School of Management Studies

MMPC-003
Business Environment

BLOCK 1: INTRODUCTION TO BUSINESS ENVIRONMENT

Unit 1: Introduction to Business and Environment
Unit 2: Economic Growth and Development
Unit 3: Socio-Cultural and Politico Legal Environment
Unit 4: Business Ethics and Corporate Social Responsibility (CSR)

BLOCK 2: OVERVIEW OF INDIAN ECONOMY

Unit 5: Indian Financial System
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Unit 10: International Financial System
Unit 11: Balance of Payments (BoP)
Unit 12: Foreign Trade
Unit 13: Sources of Global Financing
Unit 14: Technological Environment

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UNIT 1 INTRODUCTION TO BUSINESS AND ENVIRONMENT

Objectives

After reading this unit you should be able to:

- define what you mean by environment;
- explain the concept of business environment;
- describe the scope of business environment; and
- understand the basic concepts of macroeconomics.

Structure

1.1 Introduction
1.2 Business and Environment
1.3 Basic Propositions
1.4 Nature and Scope of Business Environment
1.5 Types of Business Environment
1.6 Importance of Business Environment
1.7 Environmental Analysis
1.8 Basics of Macroeconomics
1.9 Summary
1.10 Key Words
1.11 Self-Assessment Questions
1.12 References/ Further Readings

1.1 INTRODUCTION

You may have a variety of reasons for studying this course, but the main reason, we presume, is to become a successful manager. Your success or failure as a manager depends on a number of factors and these factors may not always be within your control; very often such factors constitute your work environment. These include your job, your department, your organisation, your nation and the world around you. After all, as a manager you do not function in a vacuum. You exist and operate within and not without, an environment. Therefore as a manager when you think, or take decisions, you cannot neglect the limitations of your environment. Just think for a while and then answer. Don't you arrive at decisions

after examining the possible reactions from the environmentin which you are placed ? Say, as a marketing manager, would you not study your market environment before launching a new product ? Or, as a finance manager, wouldn't you study how the capital and money markets of the country are structured and organised before deciding on the sources and uses of your funds ? Or, as a personnel managers wouldn't you care to find the rules and regulations laid down by the government on subjects like reservation before undertaking recruitment and selection of your required staff? When you have answered these questions, you will discover that all your answers are in the affirmative : "Yes, I would". You can't do without thinking about your environment. As a business manager, you have to constantly evaluate your business environment.

This opening unit aims to set you thinking about three ideas. It aims to help you to: precisely define "environment", classify your business environment on the basis ofsome criteria; identify some of the critical elements of environment of business;and establish the nature of interaction between environment and business.

In pursuing these aims and objectives, our focus will primarily be on the Indian environment of business. We shall try to identify, describe and analyse the Indian situation to understand its impact on our business. Our ultimate purpose is to train our business mangers to face the macro-level environment of business. As managers, wherever you are be it in the public or the private sector, you have to remain alive and alert to your environment so that you are successful in your day-to-day business operations.

1.2 BUSINESS AND ENVIRONMENT

The term "environment" refers to the totality of all the factors which are external to and beyond the control of individual business enterprises and their managements. Environment furnishes the macro-context, the business firm is the micro-unit. The environmental factors are essentially the "givens" within which firms and their managements must operate. For example, the value system of society, the rules and regulations laid down by the Government, the monetary policies of the central bank, the institutional set up of the country, the ideological beliefs of the leaders, the attitude towards foreign capital and enterprise, etc., all constitute the environment system within which a business firm operates. These environmental factors are many in numbers and various in form. Some of these factors are

totally static, some are relatively static and some are very dynamic – they are changing every now and then. Some of these factors can be conceptualized and quantified, while other can be only referred to in qualitative terms. Thus, the environment of business is an extremely complex phenomenon.

The environmental factors generally vary from country to country. The environment that is typical of India may not be found another countries like the USA the (former) USSR, the UK, and Japan. Similarly, the American/Soviet/British/Japanese environments may not be found in India. There may be some factors in common, but the order and intensity of the environmental factors do differ between nations. What to say of countries, the magnitude and direction of environmental factors differ over regions within a country,and over localities within a region. Thus, one may talk of local, regional, national (domestic) and international (foreign) environment of business. For example, the local custom of "coolie" labour, the climate of the northern region of Assam, the policies of the State and Central Governments in India and the size of the world market : all these factors together will have an important bearing on tea industry. The production, consumption and marketing of tea will be affected by environmental factors.

The environment differs not only over space but also over time within a country. As such, we can talk of temporal patterns of environment, i.e., past, present and future environment. Future environment is the product of past and present environments. The Indian economy of tomorrow will be influenced by what the state of the economy is at present and what it was in the past.

Sometimes the environment may be classified into market environment and non-market environment depending upon whether a business firm's environment is influenced by market forces like demand, supply, number of other firms and the resulting price competition, or non-price competition, etc., or by non-market forces like Government laws, social traditions, etc.

Finally, we may classify the environment into economic and non-economic. Non- economic environment refers to social, political, legal educational and cultural factors that affect business operations. Economic environment, on the other hand, is given shape and form by factors like the fiscal policy, the monetary policy, the industrial policy resolution, physical limits on output, the price and income trends, the nature of the economic system at work, the tempo of economic envelopment, the national economic plan, etc. The non-

economic environment has economic implications just the economic environment may have non-economic implications. Since the environment is the sum total of the history, geography, culture, sociology, politics and economic of a national, theinteraction between economic and non-economic forces is bound to take place.

Definition of Business Environment

The word 'Business Environment' is defined by many authors in different ways. Few of the definitions are as follows:

*According to **Keith Davis**, "Business environment is the aggregate of all conditions, events and influences that surround and affect it".*

***According to Reinecke and Schoell**, "the environment of a business consists of all those external things to which it is exposed and by which it may be influenced directly or indirectly".*

***According to Barry M. Richman and Melvgn Copen** "Environment consists of factors that are largely if not totally, external and beyond the control of individual industrial enterprises and their management. These are essentially the 'givers' within which firms and their management must operate in a specific country and they vary, often greatly, from country to country".*

***According to William F. Glueck** "Business environment is the process by which strategists monitor the economic, governmental, market, supplier, technological, geographic, and social settings to determine opportunities and threats to their firms".*

All these definitions give a better understanding of the business environment. It can be concluded that a business environment is a combination of dynamic, complex, and uncontrollable external factors within which a business is to be operated. It is pertinent to scan all these forces. Hence, it is crucial to have a thorough understanding of the basic idea of the business environment and the nature of its different components. This interrelation assists the business organisation to reinforce its capabilities and efficiently allocate its resources.

Business organisations interact and transact with the business environment. Therefore business organisation and business environment are directly related. Business environment influence the scope and direction of business activity.

Business can be seen as a specific activity e.g. a retail business in which a company is making use of the internet and social media for marketing of their products. For example, Flipkart is a specific form of business and is a private limited company. Business can also be seen as a broad activity like a business system as a whole where we may refer it as a market system or capitalism in which a whole range of activities including professional bodies, trade unions, consumer groups, regulatory agencies and government bodies are included.

The environment may be classified into market environment and non-market environment depending upon whether a business firm's environment is influenced by market forces like demand, supply, number of other firms and the resulting price competition, or non-price competition, etc., or by non-market forces like Government laws, social traditions, etc.

In early 2015, Nestle's famous product Maggi Noodles faced a setback in India when food inspectors claimed to have found it unsafe, as the amount of lead was more than its permissible limits. But Nestle tried its best to keep consumer trust by continuously interacting with them on social media platforms and ensuring that Maggi is safe and they are cooperating with the authorities. Later Maggi was temporarily banned in India and Nestle was asked by the Food Safety and Standards Authority of India (FSSAI) to recall its Noodles products from the market and destroy them. It hugely impacted their revenues and profits as Maggi was one of the most popular products in India.

In the second half of 2015, fresh batch of Maggi was tested and it was allowed to sell again. But lead controversy adversely affected the trust of consumers and it took lots of promotional strategies to regain the lost revenue. It launched emotional campaign # Wemissyoutoo on all social media platforms to revive the bond between consumers and Maggi brand. It took them sometime to revive from the losses and gain pre ban market share.

Activity 1

If you wish to set up an enterprise you must have a clear understanding of business environment. Identify an enterprise and study whether the business environment is conducive.

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1.3 BASIC PROPOSITIONS

As a prelude to the description and analysis of the business environment in any economy, you may examine the three basic propositions given below:

1. Business is an economic activity.
2. A business firm is an economic unit.
3. Business decision-making is an economic process.

These propositions may be examined separately or jointly to justify the study of the environment of business in any country.

Business is an economic activity

An economic activity involves the task of adjusting the means (resources) to the ends (targets), or the ends to the means. An economic activity may assume different forms such as consumption, production, distribution, and exchange. The nature of business differs depending upon the form of economic activity being undertaken and organised. For example, manufacture is primarily concerned with production; the stock exchange. For example, manufacture is primarily concerned with production; the stock exchange business of Government is to run the administration. The Government may also own, control and mange public enterprises. The business of banks is to facilitate transactions with short-term and long-term ends. These examples can be easily multiplied. The point to be noted is that each business has a target to achieve, and for this purpose each business has some resources at its disposal. Sometimes the target has to be matched with the given resources, and sometimes the resources have to be matched with the given target, Either way, the task of business is to optimize the outcome of economic activities.

A business firm is an economic unit

A business firm is essentially a transformation unit. It transforms input into outputs of goods or services, or a combination of both. The nature of input requirements and the type of output flows are determined by the size, structure, location and efficiency of the business firm under consideration. Business firms may be of different sizes and forms. They may

undertake different types of activities such as mining, manufacture, farming, trading, transport, banking etc. The motivational objective underlying all these activities is the same viz., profit maximization in the long run. Profit is essentially "a surplus value"- the value of outputs in excess of the values of inputs or the surplus of revenue over the cost. A business firm undertakes the transformational process to generate this "surplus value". The firm can grow further if the surplus value is productively invested. The firm, therefore, carefully plans the optimum allocation of resources (i.e., men, money, material, machines, time, energy, etc.) to get optimum production. The entire process of creating, mobilisation and utilisation of the surplus constitutes the economic activity of the business firm.

Business decision-making is an economic process

Decision-making involves making a choice from a set of alternative courses of action. Choice is at the root of all economic activity. The question of choice and evaluation arises because of the relative scarcity of resources. If the resources had not been scarce, an unlimited amount of ends could have been met. But the situation of resources constraint is very real. A business firm thinks seriously about the optimum allocation of resources because resources are limited in supply and most resources have alternative uses. The firm, therefore, intends to get the best out of given resources or to minimise the use of resources for achieving a specific target. In other words, when "input" is the constraining factor, the firm's decision variable is the "output". And when "output" is the constraining factor, the firm's decision variable is the "input". Whatever may be the decision variable, procurement or production, distribution or sale, input or output, decision-making is invariably the process of selecting the best available alternative. That is what makes it an economic pursuit.

1.4 NATURE AND SCOPE OF BUSINESS ENVIRONMENT

Every organisation operates in a certain kind of environment. Each organisation has some opportunities and threats associated with various forces which may be external or internal in nature.

Nature of Business Environment

1. **Dynamic:** Business environments such as internal and external business environments are highly flexible and keep on changing. For example, changing customer preferences, new competitors entering into the market, novel

technology, new marketing channels, new government policies and changing demography.

2. **Uncertain:** It is very difficult to pre assume with any degree of certainty about the factors influencing the business environment because they continue to fluctuate very quickly.
3. **Complex:** The business environment is complex as it is continuously exposed to uncertain challenges such as technological disruptions, global competition, leadership change, shifting economic, social, and regulatory conditions etc. It may be easy to scan the environment but its impact on business decisions will be difficult to estimate. It is very difficult for a firm to survive and prosper in such an uncertain environment.
4. **Relativity:** The business environment is associated with societal norms and local conditions and this is the reason, why the business environment varies from country to country, region to region which makes it more complex.
5. **Interrelation:** All the factors and forces of the business environment are related to each other. For instance, with the proclivity of youth towards western culture, the demand for fastfood is also rising. Take another example, change in political parties will result in changing monetary policy, fiscal policies, government rules, market conditions, technology, etc. Thus, all these factors are required to be scanned properly as these factors are interrelated to each other.

Scope of Business Environment

a) **Internal and external environment:** Internal environment means those factors that are within an organisation and influence the strength or weakness of the business. For example, superior raw material, inefficient human resources, etc. External environment means those factors which are beyond the control of the business and are outside the organisation. They provide opportunities and pose threats to business. For example, changing political and economic conditions, technological changes, etc.

b) **Micro-environment and macro-environment:** Sometimes internal and external environment are interchangeably reffered as micro and macro environment respectively. Micro-environment affects the working of a particular business. It directly impacts business activities and incorporates customers, suppliers, market intermediaries, competitors, etc. These factors are controllable to some extent. Macro-

environment is the general environment that impacts the working of all businesses. It is uncontrollable and influences indirectly. Political conditions, economy, technology, etc., are part of the macro environment. For example, Technological advancement such as blockchain, Artificial Intelligence (AI) have changed the face of business operations.

c) **Controllable and uncontrollable environment:** All those factors which are governed by business come under a controllable environment. Internal factors are also treated as controllable factors, such as money, men, materials, machines, etc. Uncontrollable factors are external and are beyond the control of business namely global, technological, legal and natural changes. For example, recent Corona pandemic is a major example of uncontrollable factor. The pandemic has hugely impacted the businesses and led to changes in strategies of operations.

d) **Specific and general environment:** Specific environment refers to external forces that directly influence business enterprises' decisions and actions and are directly pertinent for the achievement of organisational goals. The main forces that include the specific environment are customers, suppliers, competitors and pressure groups. General environment refers to the economic, politico-legal, socio-cultural, technological, demographic, and global conditions that influence organisations. These external forces or factors impact organisations indirectly and organisations must plan, organise, lead and control their activities by incorporating these factors.

1.5 TYPES OF BUSINESS ENVIRONMENT

There are certain factors or forces internal and external to the organisation influencing the it in both positive and negative ways. These different components of the business environment have been explained below as shown in Figure 1. 1.

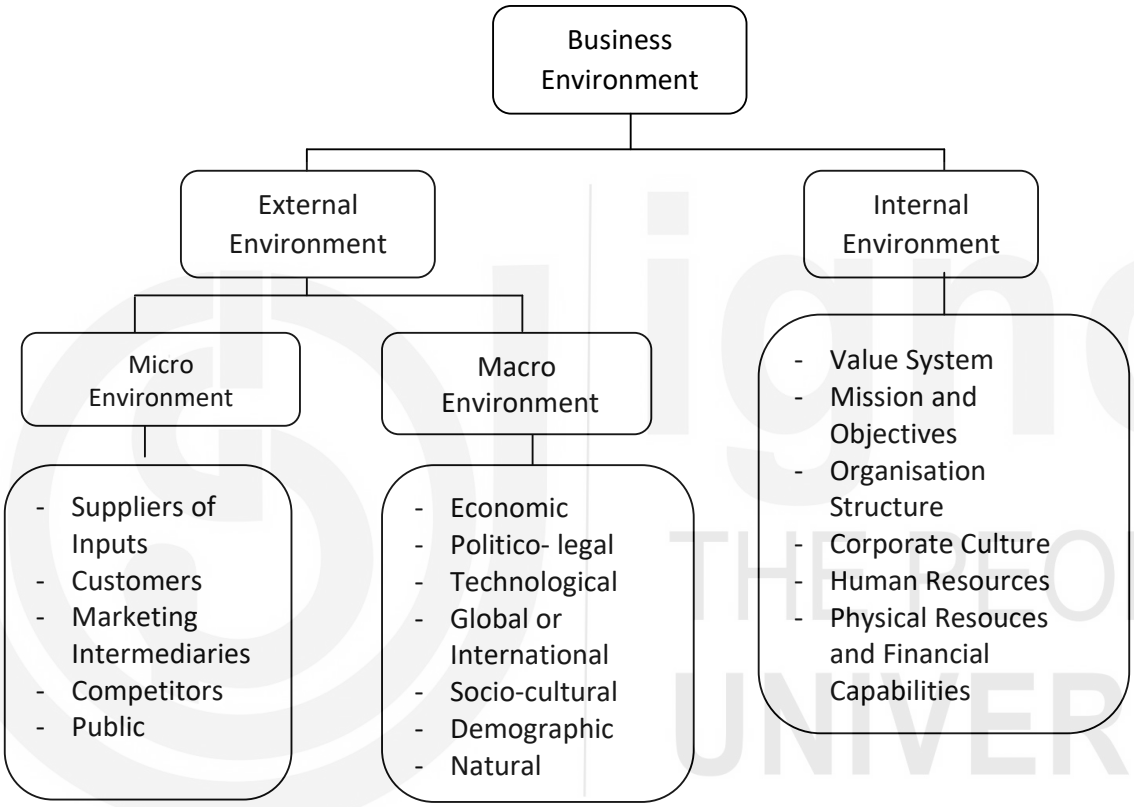

Figure 1.1: Components of Business Environment

1. Internal Environment

This includes those factors or forces that exist within an organisation influencing the performance of an organisation. These factors are controllable in nature and organisations can attempt to change or modify these factors. Organisation's resources like men, materials, money, and machines are part of the internal environment. The different internal factors are given below:

i. **Values:** The values are defined as ethical beliefs that guide the organisation in attaining its mission and objectives. These are formulated by top-level managers such as the board of directors. The extent to which these value systems are shared by all in the organisation is a significant factor leading to its success.

ii. **Mission and objectives:** Mission reflects the overall purpose or reason for organisation's existence. A mission guides and affects the decisions and economic activities of the organisation. Accordingly, an organisation can change or modify its mission and objectives.

iii. **Organisation structure:** The organisational structure is the hierarchical relationship explaining roles, responsibilities and supervision. The structure of the board of directors, the professionalism of management, etc., are the part of the organisation structure and are significant forces affecting business decisions. For effective management and working of a business organisation and for prompt decision making, the structure of the organisation should be conducive.

iv. **Culture:** Shared values and belief in an organisation determine its internal environment also known as corporate culture. Organisation having strict supervision and control reflects the lack of flexibility and unsatisfied employees. These sets of values assist the employees to understand what organisation stands for, what it considers, how it works. Cultural values of business, thus determine the direction of activities.

v. **Human resources:** Human quality of a firm is an important factor of internal environment. Skills, qualities, capabilities, attitude, competencies and commitment of its employees, etc., contribute to the strengths and weaknesses of an organisation. Organisations may find it difficult to carry out modernisation and redesigning because of resistance by its employees.

vi. **Physical resources and financial capabilities:** Physical resources, like machinery, plant and equipment facilities and financial capabilities of a firm decides its competitive strength which is the significant factor for examining its efficiency and unit cost of production. Moreover, research and development capabilities of a company decides its ability to innovate and thus increase the productivity of workers.

2. External Environment

This includes those factors or forces that exist outside an organisation influencing the performance of an organisation. These external factors can be further classified into micro-environment and macro environment which are defined below.

A. Micro-Environment: Those factors which have a direct impact on business. The different components under micro-environment are as follows:

i. **Suppliers of inputs:** The suppliers of inputs are a significant constituent of the external micro environment of an organisation. Suppliers give raw materials and resources to the firm. A firm should have more than one supplier for efficient input inflows.

ii. **Customers:** Customers are the buyers of the firm's products and services. Customers are an important part of the external micro-environment as a firm's survival and growth are dependent on sales of a product or service. Thus, it is essential to keep the customers satisfied.

iii. **Marketing intermediaries:** Intermediaries play an essential role in selling and distributing products to the final customers. Marketing intermediaries are an important link between a business firm and its ultimate customers. Retailers and wholesalers buy in bulk and sell business products and services to the ultimate consumer.

iv. **Competitors:** Competitors are the rivalry in business influencing the business strategies of the organisation. For example, Zomato and Swiggy are major competitors in food delivery business and their strategies impact each other.

v. **Public:** Public or groups, such as media groups, women's associations, environmentalists, consumer protection groups, are significant factors in the external micro-environment. The public can be defined as any group affecting a company's ability to achieve its objectives. Recently People for the Ethical Treatment of Animals (PETA) India protested against Amul (dairy company) suggested them to produce vegan milk.

B. **Macro Environment:** These are the factors or conditions which are general to all businesses and are uncontrollable. Because of the uncontrollable nature of macro forces, a firm needs to adjust or adapt itself to these external forces. These factors are as follows:

i. **Economic environment:** Economic environment refers to all those forces and factors which have an economic impact on businesses. It consists of the role of the private and public sector, monetary and fiscal policy, role of saving and investment, economic reforms, agriculture, industrial production, infrastructure, planning, basic economic philosophy, stages of economic development, trade cycles, national income, per capita income, money supply, international debt, etc. For example, an increase in Groos Domestic Product (GDP) will increase disposable income and thus further rise in demand for products.

ii. **Politico-legal environment:** Politico-legal environment constitutes all the factors related to the activities of legislature, executive and judiciary which play a leading role in shaping, directing, developing and controlling business activities. For example, rules and regulations, framed by the government, like licensing policy, Skill India movement, Digital India, Swachha Bharat Abhiyan, polythene ban, etc., affect the business. Higher business growth can be achieved in a stable and dynamic politico-legal environment.

iii. **Technological environment:** Technology is defined as the "Systematic application of scientific or other organised knowledge to particular tasks". The technology incorporates both machines (hard technology) and ways of thinking (soft technology). These organized knowledge and innovation provide new methods of producing goods and services and latest ways of operating business. Recent technological changes such as the online sale of grocery items, online booking of air tickets, online payments, etc. have changed the business strategies. As technology is changing fast, organisations should keep a close look at these technological fluctuations for their adaptation in their business activities.

iv. **Global or international environment:** The global environment includes all environmental factors having a global impact which is also important for shaping business activity. In the era of globalisation, the whole world is a market. Business analyses the international environment to cope up with the changes.

Principles and agreements of the World Trade Organisation (WTO), other international treaties and protocols such as crude oil prices are examples of the global environment.

v. **Socio-cultural environment:** The socio-cultural environment reflects customs and values which influence business practices. People's attitude towards work and wealth, lifestyle, ethical issues, religion, the role of family, marriage, education and also social responsiveness of business impact the business. For example, foreign brands like McDonalds were sensitive to Indian culture and avoided selling beef burgers in India.

vi. **Demographic environment:** Demographic environment includes the composition and characteristics of the population. For example, Population size and growth, the life expectancy of the people, rural-urban distribution of population, the technological skills and educational levels of the labour force are part of the demographic environment. These forces also impact the organisations' functioning. For example, many MNCs are targeting Indian youth because of the country's demographic dividend.

vii. **Natural environment:** Natural environment includes geographical and ecological resources like minerals and oil reserves, weather and climatic conditions, water and forest resources, and port facilities. These are very important for many business activities. For example, in places where climate conditions such as temperatures are high, demand for coolers and air conditioners will also be high. Similarly, demand for clothes and building materials is also conditioned upon weather and climatic conditions. Natural calamities such as floods, droughts, earthquakes, etc. greatly affect business activities.

1.6 IMPORTANCE OF BUSINESS ENVIRONMENT

Business environment plays an important role in the functioning of organisations in the following ways:

I. **Enable the organisation to identify the business opportunities and achieving first-mover advantage:** Many opportunities are provided by the business environment to the organisation. Scanning the business environment will help the organisation to attain the first-mover advantage.

II. **Help the firms to identify the threats and early warning signals:** The business Enterprises who can scan the business environment and obtain qualitative information on time will be able to get a warning signal to deal with negative policies and constraints of the business environment.

III. **Help in tapping and assembling resources:** Resources such as raw material, capital, money, labour, etc., are the necessary inputs to the business organisation. All these inputs are obtained through the environment to the firms for carrying out their activities and also expect something in return.

IV. **Help in adjusting and adapting to rapid changes:** Business environment scanning assists the firms to scan and understand the rapid changes in the environment and these changes are having important implications on business strategies.

V. **Assist in planning and policymaking:** The major strategic plans and policies in the organisation are formulated based on the business environment because the policies and strategies have to be implemented in the presence of these environmental factors.

VI. **Help in performance improvement:** Continuous scanning of business environments can improve their performance. By incorporating changes in the internal environment matching to external environment, business organisations can enhance and prosper their market share.

1.7 ENVIRONMENTAL ANALYSIS

We know that all organisations perform within a framework of specific factors of business environment. These can be internal as well external. A proper environmental analysis of the business environment is very important. There are different steps involved in the environmental analysis of a business. These are:

1. Scanning the internal / external factors.
2. Grouping of the scanned factors.
3. Observation of internal factors.
4. Monitoring external factors.
5. Defining the variables for the analysis.
6. Identifying specific techniques for analysis.

7. Forecasting.
8. Strategy formulation.
9. Evaluation.

In this section we will discuss SWOT analysis to familiarize ourselves with environmental analysis.

SWOT analysis

SWOT analysis is the business analysis process of examining both the internal and external environment of an organisation. Here, S, represents Strengths and W, represents Weaknesses. Both these terms are internal constituents of an organisation. While O, represents available Opportunities in the market and T, represents the possible Threats in the market. Both of these are the external constituents of the organisation (Figure 1.2).

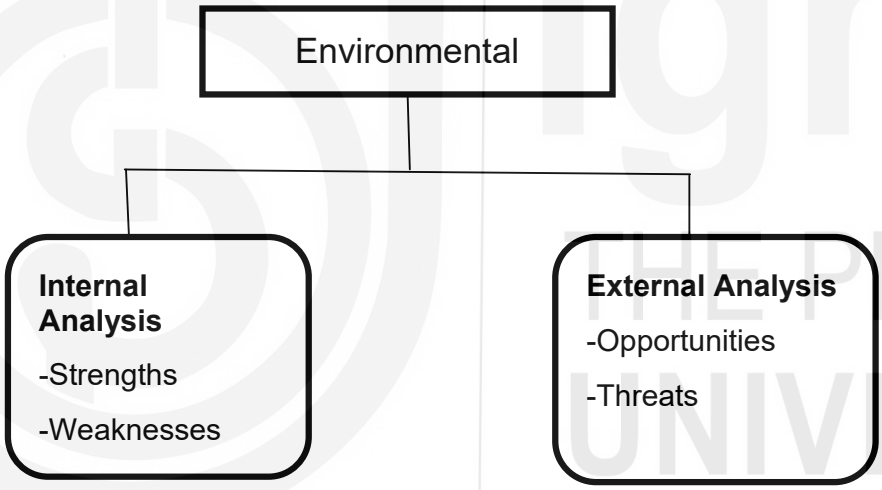

Figure 1.2: SWOT analysis Framework

a. **Strengths:** It reflects the core competencies or capabilities of an organisation for which it can achieve strategic advantages over its competitors. Even if the organisation does not gain any advantages over its competitors, it indicates an organisation's capacities in which the organisation is having affirmative aspects. For example, mobile payment platform **PhonePe** has the strength of easy user interface.
b. **Weaknesses:** Weaknesses means those factors which prevent successful results within the organisations. These are exact opposites of Strengths. Strengths indicate

competitive advantages while weaknesses indicate the competitive disadvantages of an organisation.

c. **Opportunities:** These are favourable circumstances present in the external environment, which should be grabbed by the organisation, to enhance its strengths to gain competitive advantage. An organisation strategist must be aware of the upcoming opportunity in the market so that it could grab them on time and could raise revenues and profits.

d. **Threats:** The term 'threat' reflects exposing vulnerability to something which leads to adverse impact. In an external environment, if sudden or even gradual changes occur which are not in favour of the organisation, then these represent threats to the organisation.

The SWOT analysis is a tool to evaluate the strengths, weaknesses, opportunities and threats of an organisation. Every organisation should do SWOT analysis very effectively to explore both internal and external factors of an organisation and accordingly business strategy should be formulated.

Activity 2

1. Explain the need for environmental analysis. How can it enchance organisational effectiveness?

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2. Select any company of your choice and explain the SWOT analysis of that company.

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1.8 BASICS OF MACRO ECONOMICS

Since business is an economic activity, a business firm an economic unit, and business decision-making an economic process, it is the economic environment of business which is the primary consideration in evaluating the business policies, business strategies and business tactics of a corporate entity in any national economy.

Economic transactions are the lifeline of the business and in the preceding sections, you have learnt how the business environment is influenced by the economic policies and economic structure prevailing in the country. So, students of the business environment must have some understanding of the working of an economy, what are different sectors of the economy, how they interact with one another, how monetary and fiscal policies influence the economy and so on. In the following sections, we shall study about basics of macroeconomics.

Macroeconomics is primarily the study of the behaviour and performance of the economy as a whole. The macroeconomic theories make use of macroeconomic models to explain and establish the relationship among different macroeconomic variables. Income determination, price level determination, investment, employment, product and money market equilibrium, exchange rate, the balance of payments, etc. are the main areas of macroeconomic theories. Macroeconomics also analyses the working and effects of major government policies like monetary and fiscal policies, on the economy.

According to J.M.Culburtson

'*Macroeconomic theory is the theory of income, employment, price, and money'*

According to Paul Samuelson

'*Macroeconomics is the study of the behaviour of the economy as a whole. It examines the overall level of a nation's output, employment, prices, and foreign trade'*

Interaction of Business and Macroeconomics

You must be wondering that we are students of Management then why should we worry about economics and especially macroeconomics. What is the relationship between the two? On the contrary, the understanding of macroeconomics, in particular, is of immense importance for the students of Management. Let us understand this interaction with the help of an example. Inflation is one of the prominent problems of macroeconomics. Inflation refers to the situation in which prices of goods and services rises continuously over a period of time. Inflation can affect both the consumer and producer depending upon the cause of inflation whether it is demand-pull or cost-push. If it is demand-pull or due to an increase in demand in relation to supply, then consumers are at a disadvantage. Cost-push or increase in the cost of production (for example increase in input cost) affects the supplier or producer. To alleviate the problem, the central bank of the country takes the help of the Monetary Policy. One of the instruments of the monetary policy is increasing the repo rates i.e. repo and reverse repo rate. This increase in repo rates leads to both increases in the cost of borrowing for business and a shortage of money supply in the system. These both affect the scale of production. So, producers and enterprises keep a close eye on every move of the government concerning any change in monetary policy and other policies.

Some Important Concepts of Macroeconomics

Let us understand some of the major concepts used in macroeconomics.

Net National Product (NNP) at Factor Cost (NNP_{FC}) is commonly known as National Income. The Gross National Product (GNP) or NNP can also be evaluated at factor cost. The basic cause of difference between the two concepts is that NNP arises because some of the allocations of market value do not go into the payments to the factors of production.

Gross Domestic Product (GDP)

GDP is defined "as the value of final goods and services produced within the borders of a country during a fiscal year". It also includes income earned locally by foreigners and excludes income received by the nationals from abroad.

GDP is calculated at two prices- market prices (i.e.current prices) and constant prices.

GDP at Market Price (GDP_{MP}): GDP at market price is the total value of final goods and services produced within a year at current prices.

GDP at Constant Prices: GDP at constant prices estimates GDP in reference to some base period.

For example, if we estimate GDP for 2020-21, then it will give us $GDP_{MP}$for the fiscal year 2020-21. If we estimate GDP with reference to some base year say 2004-05, then it is GDP at constant prices or real GDP. The distinction between current and constant prices is important as GDP at current prices could grow very rapidly if prices are rising. This increase will not tell anything about the volume of production whether the total output is increasing or not. On the other hand, growth in GDP at constant prices indicates a rise in the total production/output of the country.

To obtain GDP at a constant price, GDP at market price is divided by GDP deflator and multiplied by 100. GDP at constant prices is called real GDP. While calculating GDP at a constant price, the base period is always mentioned.

... Aggregate Demand and Aggregate Supply

I. **Aggregate Demand (AD):**Aggregate Demand is one of the most important concepts in macroeconomics. In simple words, it means total demand for consumer and capital goods at a given price.

$$AD = C + I + G + (X - M)$$

C= Consumption; I = Investment; G = Government Expenditure; X = Exports; and M = Imports

This equation encapsulates the gist of Aggregate Demand. In the two-sector model, there is an absence of G and (X-M) so the above equation becomes AD= C+I and investment is assumed to be constant. Ultimately aggregate demand function is largely dependent upon consumption expenditure or consumption function.

II. **Aggregate Supply (AS):** The Aggregate Supply (AS) shows the amount of output firms plan to supply at different levels of prices or the total supply of goods and services in an economy. Since firms like to sell more output with increasing product prices, the AS has an upward sloping supply curve. The intersection of AD and AS determines the short-run equilibrium in the economy.

... Multiplier or Investment Multiplier

Investment multiplier is of much importance in macroeconomics. It is a ratio of change in income/national income to change in investment.

$$m = \frac{\Delta Y}{\Delta I}$$

m = investment multiplier; ΔY = change in national income ; ΔI = change in investment. Multiplier indicates that with one unit change in Investment how much national income will change. So, it indicates the level of investment required to achieve the desired level of national income. For example, if the value of m=2 and investment is increased by Rs 100 crore then with this increase in investment level the national income will increase by Rs 200 crore.

The Four Macroeconomic Sectors

Macroeconomics has primarily four sectors and the interplay and the interaction of these sectors give momentum to the economy.

1. Household Sector

This sector covers all the individuals in the economy. The major function of this sector is to supply the factors of production to the different sectors. There are four factors of production i.e. land, labour, capital, and entrepreneur. The household sector is the ultimate consumer who consumes the goods and services that are manufactured by the firms and in return makes payments to the firms. This sector also provides the savings and supply finance to the firms.

2. Firms

This sector comprises all the businesses, firms, and corporations. The major function of this sector is to manufacture goods and supply services for sale in the economy. They hire the factors of production and pay them factor payments namely rent, wages, interest, and profits.

3. Government Sector

This sector involves the centre, state, and local governments of a country. The major function of this sector is the management and regulation of the economy. It is mostly done by its monetary and fiscal policy. Monetary policy is related to the regulation of the money supply in the economy. Fiscal policy is related to taxes, public expenditure, and public debt. Tax and non-tax sources are the major sources of revenue and revenue collected is spent on public health, services, infrastructure, etc.

4. The Foreign Sector

This sector takes into account all the economic transactions with the rest of the world. The foreign sector primarily consists of export and imports of goods and services. When we sell domestically produced goods and services to other economies, these are called exports. Imports are items that the domestic country purchases from the outside world. Net Exports are exports minus imports.

... The Three Markets

There are three major markets in an economy. These are 1) goods market, 2) factor market, and 3) financial market or money market.

1) Goods Market

In this market, goods and services are exchanged among the different sectors. The goods and services produced by the firms/industry are consumed by households, the government, and the external sector.

2) Factor Market

The factors of production are traded in this market. The factor services are demanded by the firms for the production of goods and services and these factors are paid in the form of rent, wages and profits. For example, labour is a factor of production and is owned by the household sector i.e. the workers. Workers offer their services and they are hired by firms, the government, and the foreign sector. In return for labour services, workers receive wages. This equilibrium of demand for labour and supply of labour is part of the factor market. Similar is the case for other factors of production.

3) Money Market

In this market, equilibrium is attained between demand for and supply of money. Primarily money is provided in the form of savings by the household sector and is channelized by financial institutions like banks. Firms borrow from these financial institutions and equilibrium is attained in the money market. The government regulates the money market by its monetary policy.

... Circular Flow of Income and Expenditure

The economic system can be viewed as the continuous flow of income and expenditure. It is this flow that determines the size of the national income and the overall worth of the economy. One of the major objectives of macroeconomics is income determination, so it is important to understand the circular flow of income and expenditure. This flow can be understood with the interaction of two sectors, three sectors, and four sectors.

I. Two Sector Flow

In the two-sector flow, we have two sectors namely households and firms. we have discussed the main characteristics of both these sectors in the previous paragraphs. The two sector flow is depicted in Figure 1.3.

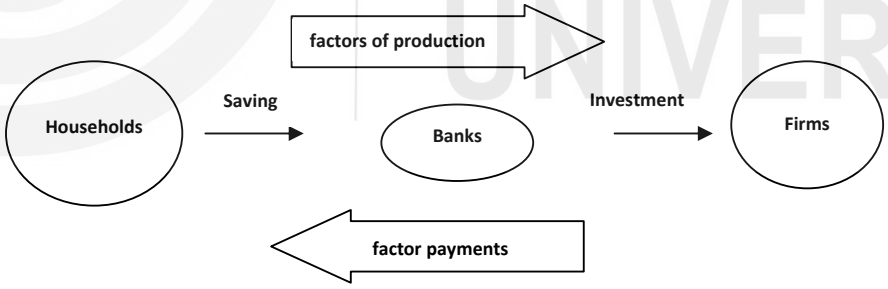

Figure 1.3 : Two Sector Flow

Households supply factors of production viz land, labour, capital, and entrepreneurs to the firms. Firms in return make factor payments rent, wages, interest, and profits to the households. The flow from households to firms represents the real flow however the flow from firms to households is money flow as all payments are made in monetary form. The money flow from firms to households ultimately becomes the total income (Y) of the

households. Similarly, there is a flow of goods and services from firms to households. In return for goods and services, households make payments to the firms which is again money flow. This continuous real and money flow gives momentum to the economy.

Financial intermediaries like banks channelise the savings from the households to the firms. The firms take the loans from the banks and other financial institutions. The primary ingredient of loan creation by banks is the savings from households. Households save their savings in the banks and then banks lend to firms.

In this circular flows of income and expenditure, there are certain leakages /withdrawals and injections/additions. For example, savings by the households represent leakages from the system. Saving is that part of income that is not consumed. The amount of saving and the size of the circular flow are inversely related. More the savings less will be the size of circular flow and vice versa. On the other hand, additional spending by households from past savings or borrowings acts as an injection or addition to the circular flow. More the spending, bigger the size of circular flow.

II. Three-Sector Model

In the three-sector model apart from the above-mentioned model one more sector i.e. government sector enters into the circular flow. This model is depicted in Figure 1.4.

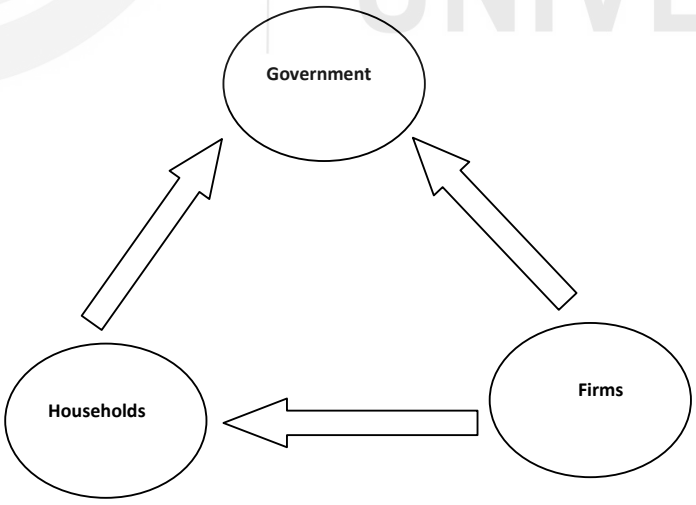

Figure 1.4 : Three Sector Model

Government affects the circular flow of income and expenditure through monetary and fiscal policy. In our model, we will only consider the fiscal policy effect i.e. taxation and government expenditure. Taxes both direct and indirect paid by both households and firms act as a withdrawal from the flow just like savings. Taxes reduce the disposal income of both households and firms which leads to a reduction in consumption and savings. On the other hand, government expenditure is like injection to the circular flow. Government expenditure gives more income into the hand of households that leads to an increase in consumption expenditure. Similarly, purchases of goods and services by the government from firms increase the income of the firms.Households also provide factors of production to the government and in return receive factor payments.

III. Four-Sector Model

Let us now learn about the four-sector model of the economy. This model includes households, firms, government, and the foreign sector.The four-sector economy has exports as inflows/injections in the national income whereas the imports are treated as leakages/ outflows from national income.

Let us briefly discuss the export function and import function.

i) Export Function

The economic growth, economic development, and equitable distribution of income depend upon the export levels of a country. Exports are needed for maintaining foreign exchange reserves in an economy. Exports also play an important role in increasing the internal trade and economic stability of a country. The exports of a country depend upon several factors. Some are listed as follows:

a. The prices of domestic goods in comparison to prices of similar goods in importing countries.
b. Trade-policy and tariff policies of importing country
c. Export subsidies
d. Income elasticity for import goods in importing countries
e. Level of imports by the domestic country

Thus, while computing national income, exports is taken as an autonomous variable and represented by X.

ii) Import Function

Imports represented by M, play an equally important role in the growth of an economy. Imports help strengthen the global presence of a country. The imports of a country depend upon the following factors:

a. Import prices in relation to domestic prices
b. Domestic tariffs
c. Domestic trade policy
d. Income elasticity of imports
e. Income levels
f. Export levels

When the value of exports is more than the value of imports (i.e. X > M) we call it trade surplus. However, when the value of imports is more than the value of exports (i.e. M > X) it is called a trade deficit and represents an unfavourable situation for any economy. The four sector circular flow is shown in figure 1.5.

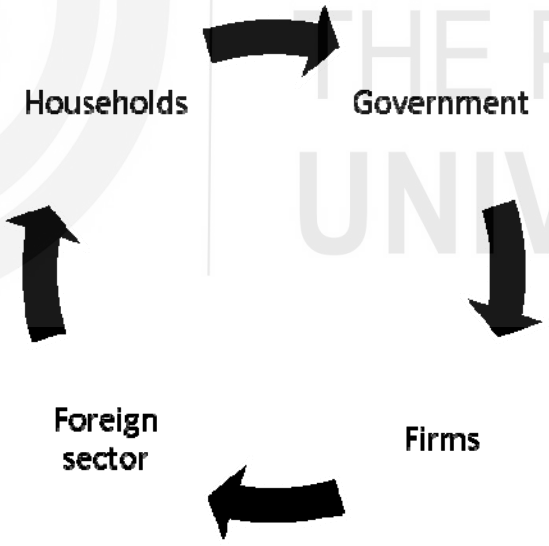

Figure 1.5: Four Sector Flow

Let us assume that Households only supply labour to the foreign sector and in return, they receive foreign remittances (money sent by a person residing abroad to their families in a

domestic country). Firms make payments for imports to the foreign sector and firms receive exports receipts. The foreign sector provides different taxes and tariffs to the government and the government in return formulates various schemes and policies which facilitates trade. If the trade balance is positive (i.e,. X > M) then circular flow increases as it increases the magnitudes of circular flows of income and expenditure.

Activity 3

1. Visit the website of the Ministry of Statistics and Programme Implementation and find out the value of GDP at both current and constant prices for the last 5 years and notice the change in both the series. Also, find out the change in the base year for the calculation of GDP.

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2. Read the Economic Survey of India for the year 2021-22 and make the list of important exports and imports of India and also analyse the change which has taken place in the composition of both exports and imports.

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1.9 SUMMARY

The environment is a complex phenomenon. The term environment consists of several subsets, e.g., economic environment, socio-cultural environment, politico-legal environment, technological environment, etc. It thus represents the totality of all kinds of environments which have an impact on business. To a large extent, the environment is external to the firm. Business firms in general have little influence on external forces. Depending upon the nature and composition of several subsets of the environments, the business environment varies from country to country, and may even vary in the same country from one point of time to another. A number of problems are involved in the identification, description, explanation and prediction of environmental factors. The environmental factors are dynamic. It is difficult to conceptualise and/or quantify the proportion of change as well as the direction of change in environmental factors.

Since the environment and the economic institutional framework affect business organisations, it is imperative on the part of the management to scan the environment before taking any decisions. The success of any business enterprise in a large measure, would depend upon the proper understanding of the business environment.

Macroeconomics studies concepts like national income, nationwide employment, aggregate demand, aggregate supply etc. It deals with the aggregates of all quantities as opposed to microeconomics which deals with individual quantities. There are four macroeconomic sectors, viz the Household Sector, firm sector, government sector and foreign sector. The concept of aggregate demand and aggregate supply is the total demand and total supply of the entire economy. Further, the concept of investment multiplier is of much importance to analyse the effect of investment on the national income.

1.10 KEY WORDS

Environment : The totality of all factors or forces affecting business and external to and often beyond the control or influence of individual business enterprises. The environment comprises several subsets, e.g., economic environment, socio-cultural environment, politico-legal environment, technigological environment, etc.

Internal Environment : Consists of factors existing within business organisations and which are controllable.

External Environment: Refers to forces / factors outside an organisation and which are by and large byond the control.

Economic Activity : Any activity undertaken with economic or financial motive or consideration. In the business context, it is the task of adjusting the means/resources to the needs/targets.

Decision-Making : Making a choice from a set of alternative courses of action.

Environmental Analysis: The process through which an organisation monitors and comprehends various environmental forces in order to identify the opportunities and threats.

1.11 SELF-ASSESSMENT QUESTIONS

1. Explain the concept and nature of business environment.
2. Distinguish between micro environment and macro environment.
3. What are the various elements of internal environment of business?
4. Explain the process of environmental analysis.
5. How environmental analysis can enhance organisational effectiveness? Discuss in detail.

1.12 REFERENCES/ FURTHER READINGS

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UNIT 2 ECONOMIC GROWTH AND DEVELOPMENT

Objectives

After reading this unit you should be able to:

- explain the concept of economic growth, economic development and some indicators of economic development;
- discuss the Harrod-Domar model, Solow model, Endogenous growth theory and major theories of under-development;
- familiraize with national income accounting, Gross Domestic Product (GDP), various concepts related to national income along with three major methods of estimating national income; and
- discuss Inflation and its effect on various aspects of the economy.

Structure

2.1 Introduction

2.2 Theories of Economic Growth

2.3 National Income

2.4 Inflation

2.5 Summary

2.6 Key Words

2.7 Self - Assessment Questions

2.8 References/ Further Readings

2.1 INTRODUCTION

Achieving a higher rate of economic growth is the objective of every nation around the world. It is because of economic growth that production, employment, income, saving and investment in the country increases. The standard of living improves and the people of the country prosper. But how can this objective be met? what are the major factors which contribute to achieving higher rate of economic growth? The various growth models and theories given by economists provide an answer to this problem. The economic literature is

full of many theories like classical, Marxist, neoclassical and many others who have tried to investigate the reasons behind underdevelopment and the possible solutions.However, in this unit, you will learn about few models like Harrod-Domar, Solow and endogenous growth theory along with some theories of underdevelopment.Harrod-Domar theory highlights the role of saving and investment in achieving higher economic growth, the Solow model talks about the importance of technology and capital accumulation whereas endogenous growth theory emphasises the role and importance of investment in human and physical capital. Having understood these theories in the next section you will read about national income, various concepts related to national income and various methods of estimating it. Further, in the last section, you will get yourself familiarise with the concept of inflation and how does it impact different sections of society.

2.2 THEORIES OF ECONOMIC GROWTH

You all must have heard or read at one time or another that some countries of the world like USA, Germany, etc. are termed as developed countries. On the other hand, countries like India, China, etc. are classified as developing. Now you might be guessing how countries are labelled as developed, developing or underdeveloped and why is it so that some are developed and other underdeveloped. Well, the answer lies in the per capita income (PCY), Gross Domestic Product (GDP) and Gross National Income (GNI). Countries are classified into various categories of development and level of income based on a certain level of income threshold. These thresholds are defined by different world organisations like United Nations, World Bank, etc from time to time.

Economic growth indicates an increase in the national income and total output of the country. The growingGDP, Gross National Income (GNI) and production capacity of the country are some of the indicators of the economic growth of a nation. Economic growth can be viewed as the material wellbeing of a country. On the other hand, economic development implies an upward trend in the real income of the country over a long period. According to Schumpeter economic development is a change in the stationary state of the economy. This change is erratic, spontaneous and discontinuous. It is a movement from one equilibrium point to another. It is a steady and gradual change that happens in long run and is a result of a general increase in the rate of savings and population. It also implies a per capita increase in the production of a country. Achieving a higher level of economic growth and economic

development are major planning goals of every nation. It is with a higher level of total output that the standard of living, productive capacity and overall efficiency of the nation increases. It is because of the increase in GDP that employment increases and more peoplefind jobs. With an increase in employment level, income level improves and the problems of poverty and deprivation can be eradicated.

Purchasing Power Parity (PPP)

One of the important curiosity among individuals/politicians/economists is to compare their country with another and then draw many conclusions as per their convenience. However, there is a well-developed methodology to do and it is called Purchasing Power Parity or PPP. PPP is used to make comparisons between economic growth and standard of living among nations. This task of international comparison is lead by World Bank through its statistical initiative known as International Comparison Program (ICP). ICP provides comparable price and volume measures of GDP and its expenditure aggregates among countries and publishes PPP of the world's economies.

PPP measures the purchasing power of the currency. It measures the total amount of goods and services that a single unit of a currency of one country can buy in another country. For example, if a pair of shoes cost Rs 1000 in India and if the same pair of shoes cost $50 in the USA then the exchange rate between the US dollar and Indian rupee is $1= Rs 20. It means $1 is equal to Rs 20. PPP is used to convert the cost of a basket of goods and services into common currency and in this process, the price difference is eliminated across countries. PPP equalises the purchasing power of currencies. It was important to discuss the PPP as data on various developed indicators is published using the PPP approach.

Measurement of Economic Development

Economists are interested in measuring economic development because it can help in ranking the countries and making meaningful comparisons. From time to time attempt has been made to measure economic development with some socio-economic indicators ranging from Social Development Index of United Nations Research Institute on Social Development, Physical Quality of Life Index (PQLI) of Morris D Morris to Human Development Index (HDI). In Modern times HDI is one most widely accepted index. Let us understand how does it work and rank countries. HDI is prepared by United Nations Development Program (UNDP) and was developed by economist Mahbub Ul Haq. It is a composite index made from 3 indicators measuring key dimensions of human development. These three indicators are life expectancy

(life expectancy index), expected years of schooling and mean years of schooling (education index) and a decent standard of living measured by GNI per capita (PPP $) (GNI Index). The top 5 countries in the HDI ranking of 2020 were Norway (1st), Ireland (2nd), Switzerland(3rd), Hong Kong and Iceland (both 4th) and in the same ranking, India stood at 131 ranks out of 189 countries.

World Bank has prepared the list of countries based on income level. World Bank has divided countries into 4 categories namely low- income economies, lower-middle-income economies, upper-middle-income economies and high-income economies. The following table presents the summary of the World Bank classification for the 2021 fiscal year.

Classification of Countries on the basis of Income

Classification of Economies	**Income Level (Gross National Income per capita)**	**Countries ***
Low-income	of $1,035 or less in 2019	Afghanistan, Haiti, Somalia, Madagascar, Ethiopia
Lower middle-income	$1,036 and $4,045	India, Sri Lanka, Bangladesh, Bhutan, Myanmar, Pakistan
Upper middle-income	$4,046 and $12,535	China,Thailand, Cuba, Maldives, Tuvalu
High-income	$12,536 or more	USA, UK, Finland, France, New Zealand, Germany, Norway, Gibraltar, Oman

Source: World Bank

*The list include only major countries for more details visit World Bank webiste

In the preceding paragraph,we have discussed economic growth and economic development and its importance, now in the following section, we will discuss in short, some major theories of economic growth namely the Harrod-Domar model, Solow model, endogenous growth theory and major theories of underdevelopment.

HARROD-DOMAR MODEL OF ECONOMIC GROWTH

This model of economic growth was given by two economists namely Roy Harrod and EveseyDomar in the early 1950s. This model highlights the role of saving and investment in economic growth. According to this model,the growth rate in an economy is dependent upon two factors. One is the saving-income rate (S/Y) and the second, capital-output ratio (the

amount of capital required to produce a unit of output). The model is based on many assumptions like no government interference in the working of the market (Laissez-faire), full employment in the economy, closed economy, the law of constant returns to scale, neutral technical progress, etc.

In this model, three growth rates are explained namely actual growth, warranted growth rate and natural growth rate. The actual growth rate is determined by the actual rate of saving and investment. It is expressed aschange in income divided by total income ($\frac{\Delta Y}{Y}$). This growth rate is determined by the saving-income ratio and capital-output ratio and its relationship can be expressed in the following functional form.

$$GC = s$$

Or

$$G = \frac{s}{C}$$

In above equation ,G = actual growth rate;

C = capital-output ratio; $\frac{\text{change in capital stock}}{\text{change in income}}$ or $\frac{\Delta K}{\Delta Y}$ or $\frac{I}{\Delta Y}$ (I = investment) and

s = saving-income rate ($\frac{S}{Y}$)

For example, if the saving rate of an economy is 10 % and the capital-output ratio is 2, then the economy would grow at 5 % per annum.

Warranted Growth Rate

The warranted growth rate is also known as full capacity growth rate or potential growth rate. If the economy is making optimum use of its resources and working at full capacity then we can say that this is the warranted rate of growth or G_w .

Natural Growth Rate

This rate of growth an economy can achieve with the help of natural resources. Factors like capital equipment, technical knowledge, amount of fertile land, minerals and forest cover, etc. determine the natural growth rate of an economy. This is the upper limit or the ceiling beyond which we cannot go. It is denoted by G_n.

Harrod-Domar model highlights that investment has a dual role to play. It increases income on one hand via multiplier process and on the other hand, it enhances the productive capacity

of the country. Further, lack of saving and deficiency of investment are major bottlenecks in the path of economic growth. So there is a need to mobilise domestic savings or create a domestic environment conducive for generating investment and achieving higher economic growth.

SOLOW MODEL OF ECONOMIC GROWTH

Solow model is also known as neoclassical growth theory and was propounded by Robert Solow of Massachusetts Institute of Technology in 1956, also awarded Nobel Prize for Economics in 1987. This model propounds that changes in population growth rate, rate of technological progress and saving rate bring about changes in the level of output. There are three basic propositions of neoclassical growth theory. First, the growth of output in the long-run steady state is determined by the rate of growth of the labour force and the rate of growth of labour productivity. Second, the level of per capita income (PCY) depends upon the rate of saving and investment to GDP. Third, there will be convergence in the income levels of different countries with certain assumptions related to labour force growth, savings,depreciation andproductivity growth.

The major assumptions of the model are:

I. The labour force grows at a constant exogenous rate
II. Constant returns to scale
III. Output is a function of capital and labour and both factors are subjected to diminishing productivity.
IV. The elasticity of substitution is equal to 1.
V. All of the saving is converted into investment i.e. no independent investment function.
VI. Variable capital-output ratio.

Production Function

In the Solow model, the production function can be presented as

$$Y = F(K, L) \qquad (1)$$

Where Y = Output; K = capital ; L = Labour and F is the functional relationship between output and inputs. The important property of the production function is that it exhibits

constant returns to scale. It implies that if inputs increase by 10% then the output will also increase by 10%.

$$\emptyset Y = F(\emptyset K, \emptyset L) \qquad (2)$$

In the above equation, $\emptyset$ is some positive number and in our preceding example the value of $\emptyset$ is 10 %. Now if you put $\emptyset = 1/L$ in equation 2, then

$$\frac{Y}{L} = F\left(\frac{K}{L}, \frac{L}{L}\right) \text{ or } F\left(\frac{K}{L}, 1\right) = y = f(k) \qquad (3)$$

In the above equation, $y = \frac{Y}{L}$ is output per worker and $k = \frac{K}{L}$ is capital per worker. Equation 3 also states that output per worker is a function that depends on the amount of capital per worker. The graphical representation of the production is given in the Figure 2.1.

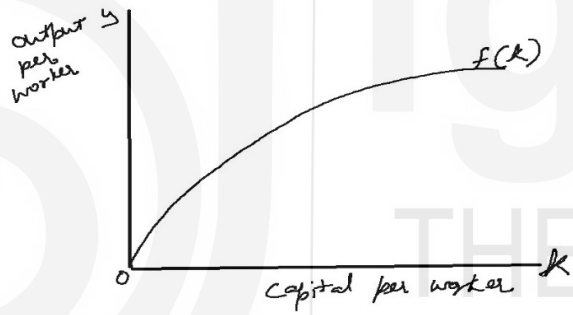

Figure 2.1: Production Function

The slope of the production function in Figure 2.1 shows how much extra output per worker is produced from an extra unit of capital per worker. As we have stated in the assumption that diminishing return operates. It is because of this reason that the production function assumes a flat shape as the amount of capital per worker increases or k increases.

Evolution of Capital and Steady-State

In the above section, you have understood about production function and now you will examine how capital stock impacts economic growth. The change in the capital stock is affected by two forces investment and depreciation of capital. How much proportion of output will be allocated between consumption and investment is determined by saving rate S. At any particular level of k, the output is $f(k)$, investment is $sf(k)$ and consumption is given as $f(k) - sf(k)$. The higher the level of capital k, the greater the levels of output and

investment. Further, a constant function δ represents depreciation which takes place in capital stock every year. Solow model predicts that the saving rate is one of the key determinants of the steady-state capital stock. γrefers to labour productivity growth rate and labour force grows at the rate 'n' per year. The total capital stock will tend to grow when savings are greater than depreciation but capital per worker will grow when savings are greater than what is needed to equip new workers with the same amount of capital that was available with the existing workers.

The Solow equation (given in equation 4) shows the growth of capital-labour ratio (k) depends on savings ($sf(k)$, depreciation(δ) and labour force(nk).

$$\Delta k = sf(k) - (\delta + n)k \qquad (4)$$

In the Solow model, steady-state refers to a state in which output and capital per worker are no longer changing. To find a steady-state, let us assume $\Delta k = 0$ then equation 4 will become:

$$sf(k*) = (\delta + n)k^* \qquad (5)$$

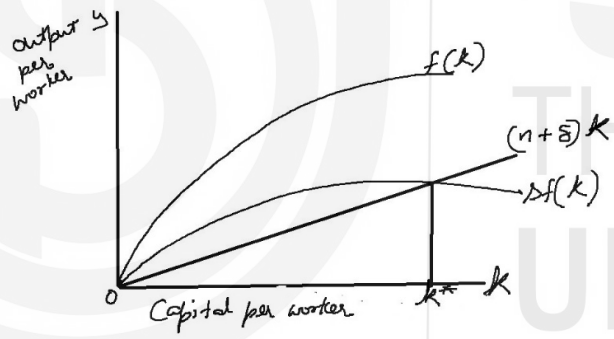

Figure 2.2: Equilibrium of capital per worker and output per worker.

From equation 5 and Figure 2.2, we can see that k^* is the level of capital per worker when the economy is in its steady state. The equilibrium which is attained in the above figure is the stable equilibrium and it highlights that saving per worker ($sf(k^*)$) is just equal to δ k^*, the amount of capital per worker needed to replace depreciating capital and nk^* which needs to be added to labour force growth. In the steady-state, if k is higher or lower than equilibrium k^*, the economy will return back to its original equilibrium value. As you can see from the diagram that if for some reason we are on the left of k^*, then $k < k^*$ and $(n+\delta)\, k < sf(k)$ and in this scenario, $\Delta k > 0$, and because of this result k in the economy will grow and move toward equilibrium point k^*.

In the above section, you must have understood the neo-classical model, further one of the major implication of this model is that there will be conditional convergence in the level of income of various economies.

Endogenous Growth/ New Growth Theory

The central idea of endogenous growth theory is that the economic growth of a nation is generated by the factors which are within the production process or endogenous like technological change or increasing returns to scale rather than exogenous factors. GNI growth is a natural consequence of long-run equilibrium. This conclusion is in contrast to the famous belief of the neo-classical theory. The major objective of this new growth theory is to explain differences in the growth rate observed by developed and underdeveloped countries. Further, the theory assumes increasing returns to scale in production function which implies that proportionate change in output will be more than proportionate change in inputs. Moreover, they have highlighted the role of externalities and further propagated that these externalities do impact the rate of return on capital investment. Externalities are the cost or benefits that originate from either production or consumption of a good or service. Heavy investment in human capital like providing training, imparting skill, etc generate external economies which mitigates the negative effect of diminishing returns, rather it leads to increasing returns to scale and a higher level of productivity.

The simple equation explaining endogenous growth can be expressed as :

$$Y = AK$$

Here Y refers to output or growth and A is the constant marginal productivity of capital i.e. K. Above type of production function is linear in nature. In the above equation, K, not only includes physical capital alone but human capital also. Endogenous growth theory propagates the important role of saving and human capital investment in achieving a higher level of growth. The higher the level of savings in the economy, the higher will be capital stock and national income.

Similarly, this theory also explains that a higher level of the international flow of capital widens the inequality gap between developed and underdeveloped countries. According to theory, developing countries offer a higher rate of returns on investment which lures the capital flow towards these countries. But developing countries have much lower levels of complementary investment in human capital (investment that supplements and support other

productive factors). These countries are marred by a lower level of investment in infrastructure, education, schooling, research and development. So, these countries are unable to fully utilise the benefits of international capital flows. Complementary investments create positive externalities and when these private and social benefits are realised, the government also contributes to efficient resource allocation. More and more public goods (like roads, railways etc) are created by the government agencies. Similarly, the government can encourage private investment in knowledge-intensive industries like education, training, etc which leads to the creation of more and more human capital. These changes ultimately help in mitigating the drawback of diminishing returns. Endogenous growth theories suggest that government or public policy should work in the direction of expanding the budget and expenditures on the creation of human capital and promoting/creating a conducive environment that attracts foreign private investment in the fields like software development, information and technology, telecommunication, etc.

Major Theories of Under-Development

In the economic literature, there are a vast number of theories related to under-development. As discussing all of them are beyond the scope of this unit, we present the details about major theories of underdevelopment namely vicious circle of poverty, low-level equilibrium trap, critical minimum effort, big push and stages of economic growth.

The Vicious Circle of Poverty Theory: This theory is associated with Prof Nurkse who propounded that the main reason for the backwardness of underdeveloped countries is the vicious circle of poverty. According to Prof Nurkse, the vicious circle of poverty is-

" circular constellation of forces tending to act and react in such a way as to keep a country in the state of poverty"

Figure 2.3 illustrates how this circle works from both supply and demand side. From the supply side, low income, low rate of savings and investment, low rate of capital formation which leads to low productivity and production. From the demand side, low income leads to low consumption and demand for goods and services which creates less incentive for investment and production. Underdeveloped countries need to break this circle with the help of entrepreneurship and the labour force.

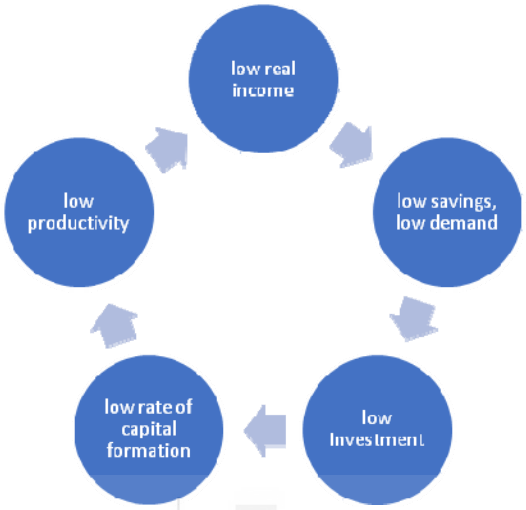

Figure 2. 3: Vicious Circle of Poverty

Low Level of Equilibrium Trap Model: Richard Nelson (1956) gave this theory of low level of equilibrium trap in which he highlights that underdeveloped are trapped in a low level of income. He propounds that in UDCs there is low per capita income. It is because of poverty that individual's income levels are low which are the cause of low saving and investment rate and ultimately low national income. Accordingly, a quantum leap above minimum per capita income is required to above which people are able to raise the level of savings and this results in a higher level of national income and economic growth.

Critical Minimum Effort Theory: The critical minimum effort theory is associated with economist Harvey Leibenstein. Leibenstein was of the opinion that underdeveloped countries were entrapped in the vicious cycle of poverty and to rise above this poverty trap a minimum level of investment or critical minimum effort is needed. This minimum level of investment is of paramount importance for raising per capita income and economic growth. According to the theory in every economy there are two forces : a) income depressing forces (or shocks) that lead to a fall in per capita income and b) income-generating forces (or stimulants). The main feature of underdeveloped economies is that income depressing forces are abundant and are one of the main reasons for their underdevelopment and to overcome these hurdles or to break the chain of underdevelopment a critical level of investment is needed.

Theory of Big Push: Prof. Paul N. Rosenstein Rodan gave the theory of big push in 1943. According to the theory of big push, 'bit by bit' investment programme will not yield the

desired result in underdeveloped countries and they need huge and comprehensive investment package (big-push) to move from the stage of underdevelopment towards development. Citing an example of an aeroplane he says that an aeroplane needs some critical ground speed to take off and become airborne. Same for an economy a big push is needed to unshackle itself from chains of underdevelopment. He has identified three kinds of indivisibilities intending to specify the areas where big push needs to be applied namely indivisibilities in the production function, indivisibility of demand and indivisibility of savings. Indivisibilities in the production function may be due to inputs, output or processes and these lead to increasing returns. An important form of indivisibilities is the social overhead capital like infrastructure which area major obstacle to economic development and a large sum of investment is required to overcome this obstacle. Indivisibilities in demand requires that investment be made in many industries which could mutually support each other instead of just concentrating on a few for the purpose of complementary demand. Lastly, underdeveloped countries face a huge dearth of supply of savings due to low-income levels and this leads to low investment.

Rostow's Stages of Economic Growth: Rostow (1959) presented the 5 stages of economic growth which all countries must pass to become developed. The 5 stages are traditional society, precondition to take off, take off, drive to maturity and age of high mass consumption. Traditional society is predominant agrarian and production function is primitive with no scientific temper or perspective. In precondition to take off which is the transitional phase, ideas begin to germinate for economic progress and better lives for the present and future. Manufacturing began to develop along with agriculture and the establishment of institutions for mobilising savings and investment. Take off stage is marked by dynamic changes in society and a substantial increase in the standard of living. Take off stage requires the rate of investment which is the range of 5 to 10 % of GNP. Development of the manufacturing sector and the existence of social, political and institutional framework is another feature of the take-off stage. According to Rostow after 40 years of takeoff stage, there is a long interval. In this interval, diversification takes place in all sectors of the economy. Multiple industries are set up and the process of industrialisation is highly sophisticated and manufacturing of consumer durables picks up along with capital goods. A large investment is taken up in infrastructure both physical and social. In the age of high consumption, the industrial sector dominates the economy, people have a large amount of disposable income and the urbanisation process gain heavy momentum.

Activity 1

1. Discuss some of the features and limitations of Harrod-Domar Model of growth.

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2. What are the various stages of economic growth as mentiond in Rostow Theory? In your opinion, Indian Economy is passing through which stage, support your answer with data and figures.

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2.3 NATIONAL INCOME

The health and wellbeing of an economy can be judged by the amount of total income that the citizens of the economy are earning. National Income accounts help us to understand the growth and trajectory of the economy. The figures of national income accounting (NIA) are used to make international comparisons. It shows how our country is doing (economically) in relation to other countries. The planning process of any country is heavily dependent on these numbers. The interrelationship between different players in the economy can be better understood in the light of these estimates.

In the NIA, Gross Domestic Product (GDP) is one of the most essential components. The entire series of national income revolves around this component. Most importantly figures of national income are derived from the figures of GDP. So to understand national income it is essential to understand this component. GDP in the simplest sense is the market value of all

final goods and services which are produced by the residents of a country within the domestic territory of a country in a given period of time.

Before we move further few points about GDP needs to be understood. **First**, it is the market value of final goods and services. Market value is reflected as market prices and market prices indeed represent the willingness to pay by the consumers. So, the value of goods and services are reflected by market prices. **Second**, it includes only the value of the final goods. It means that the intermediate goods are excluded when calculating GDP. It is because to avoid the problem of double counting. **Third**, goods and services produced by the residents of the country within the boundaries of the country are included. **Fourth**, it measures the value of production which takes place within the specific time period usually fiscal year or a quarter.GDP indeed measures total income and total expenditure in an economy. However, they both are the same because for an economy as a whole income must equal expenditure.

Let us take an example. In every economic transaction, there are two parties namely buyer and seller so one person's income is the other's expenditure. For example, Mehta decorator and painters were given the order to paint the courtyard of Mr Verma and the deal was signed off with the contract of Rs 10,000 for doing this work. In this example, Mr Verma is a buyer of the service and Mehta decorator and painters is the seller. The company earns Rs 10,000 and Mr Verma spends Rs 10,000. In this example, the amount of Mr Verma expenditure is equal to Mehta decorator and painters income. So, whether you measure GDP from the Income side or expenditure side,it will rise by Rs 1000 in the above example.

Different Concepts related to National Income

Gross National Product or GNP: It is the market value of all final goods and services produced in the year alongwith net factor income from abroad (NFIA). NFIA is the difference between factor income received (like rent, interest and profit) from abroad and factor income paid abroad.

$$GNP = GDP + NFIA$$

Net National Product or NNP = It is the market value of all final goods and services produced by country citizens both domestically and internationally in a given period. NNP is indeed national income that is available to the economy for consumption and investment. NNP divided by total population gives per capita income.

$$NNP = GNP - Depreciation$$

Net Domestic Product (NDP) = It refers to the economic output of the country adjusted for depreciation (or consumption of fixed capital).

$$NDP = GDP - Depreciation$$

Market Price (MP): When any measure of national income like NNP is calculated at a market price it includes the cost of production and also various taxes/subsidies which are imposed and provided by the government. Net Indirect tax isthe difference between indirect tax (like Goods and Services Tax or GST, Value-Added Tax or VAT)and subsidies.

$$NNP_{MP} = NNP + \text{Net Indirect Taxes (NIT)}$$

Factor Price(FP): In contrast to market price, factor price excludes the effect of NIT.

$$NNP_{FC} = NNP_{MP} - NIT$$

Personal Income (PI): PI is the income which an individual or households receive from all the sources before paying taxes. It includes income from factor services like wages, rent and interest along with transfer payment, payments like pensions, social security benefits. The personal income includes transfer payment which is not included in national income.

Disposable Income: It is income that is left with individuals after paying taxes and other compulsory payments to the government. It is the actual amount of money that is in the hands of the individual for consumption and other expenditures.

$$\text{Disposal Income} = \text{Personal Income} – (\text{taxes} + \text{fees} + \text{fines})$$

Different Approaches of Estimating National Income

There are three approaches of measuring national income namely:

- Product Method or Value Added Method
- Income Method, and
- Expenditure Method

There is one common thing about these three methods, the figures of GDP will be the same irrespective of any method which you use in estimating National Income.

Product Method or Value Added Method

Under the value added method,GDP is calculated by the sum total of gross value added of all the firms in the economy. Value added by a single firm is obtained by the substracting value of intermediate goods from the value of output. Let us understand this with the help of an example. Suppose there are two producers in the economy, one producing cotton and the other producing cloth. To simplify, we assume that the cotton producer uses only one input i.e. human labour and he sells some proportion of cotton to the producer producing cloth. On the other hand, cloth producer also makes use of only one input i.e. cloth. The total value of cotton that the cotton producer has produced is Rs 500. Out of this Rs 500, cotton worth 450 was sold to the cloth producer. The cloth producer having used cotton worth Rs 450 produced cloth whose value was estimated to be Rs 1500. Based on the example cited above, what is the value of total production in the economy? If we were to simply add up the contribution of each producer then the value of total production would be Rs 500 (share of cotton producer) + Rs 1500 (value of output created by cloth producer) will equal Rs 2000.

However, this estimate is not correct. The value of output which the cotton producer has generated is indeed Rs 500 as he has not paid any amount for the use of intermediate goods (raw material). Though the same is not true for cloth producer. For calculating the net contribution of his, we need to subtract the value of intermediate good (i.e. cotton) which amounts to Rs 450 from his contribution. If we do not do this exercise then we commit the error called 'double counting' (counting the value of good more than once). In our case, Rs 450 worth of cotton will be counted twice. One, as part of total output produced by cotton producer and second as the value of input while producing cloth. So, the value added by the cloth producer will be Rs 1500 (value of output) – Rs 450 (value of intermediate good) = Rs 1050. The aggregate value of production in the economy consisting of these two producers will be Rs 500 + Rs 1050 = Rs 1550.

Here at this point, it is necessary to introduce you to the concept of depreciation also known as consumption of fixed capital. Capital goods like the plant, building etc, when used in the production process are subject to deterioration which is called depreciation. If we subtract the value of depreciation from the gross value we arrive at the new concept 'Net value'. For instance, in the previous section you learnt about NDP.

$$NDP = GDP - Depreciation$$

And similarly, we can estimate the value of Net Value Added as

$$\text{Net Value Added} = \text{Gross Value Product} - \text{Depreciation}$$

So if we add up the net value added of every good produced we arrive at national output.

Income Method

In the productionprocess, the producer makes use of factors of production namely land, labour, capital and entrepreneur. In return for their services rendered they receive rent, wages, interest and profit combinedly called factor payments. Under the income method, national income is measured by aggregating these factor incomes generated by different producing units within the domestic territory of the country in one fiscal year.

The different components of the income method are the compensation of employees, rent, interest, profit and mixed-income. Wages and salaries paid in cash and kind and the contribution made by the employer to the social security scheme of employees are the major components of compensation of employees.

Rent is the payment that accrues from ownership of land and building. Interest is the payment that one receives from lending his funds. Profit is earned by an entrepreneur and it has three components corporate tax, dividend and retained earnings. Corporate tax is the tax paid to the government. The dividend is paid to the shareholders of the company and some part of the profit is retained as the reserves to meet unforeseen contingencies or for business expansion and growth is termed as retained earnings. Income earned by self-employed persons is termed as mixed-income.The sum of these five components gives us the value of the net domestic product at factor cost (NDP_{FC}).

NDP_{FC} = Compensation of employees+ Rent + Interest+ Profit + Mixed Income of self employed

Further adding net factor income from abroad NFIA(difference between factor income which is received from abroad and paid abroad) gives the value of the net national product at factor cost (national income).

$$NNP_{FC} = NDP_{FC} + NFIA$$

Expenditure Method

Under the expenditure method of estimating GDP the demand side of the products is looked at. GDP is the sum total of all the expenditures made on the final goods and services within the country. Following equation summaries GDP as:

$$GDP = C + I + G + (X - M)$$

In this equation C, I, G, X and M stands for C = private consumptionexpenditure,I = Investment made by households and business, G = Government expenditure, X = Exports of goods and services, M = Imports of goods and services.

Major Components of the Expenditure Method

i. Private consumption expenditure: It includes expenditure by the households on both durable and non-durable goods along with different services.

ii. Investment or gross fixed capital formation : It included expenditure undertaken by both households and government for investment purposes.

iii. Government expenditure: Expenditure undertaken by the government on the purchase of goods and services along with expenditure on building infrastructure, payment for salaries, etc.

iv. Net export: It is the difference calculated by substracting total imports from total exports. It represents the contribution of the foreign sector to the GDP.

Some Precautions While Estimating National Income

Following items must be excluded while measuring national income.

- The expenditure of intermediate goods and services otherwise it will encounter the problem of double counting.
- Transfer payments like scholarships, pension, etc.
- Income earned from second-hand goods.
- Income from sales of shares, bonds, windfall gains like lotteries.

Activity 2

1. Visit the website of the National Statistical Office, Ministry of Statistics & Programme Implementation, Government of India and analyse the trends in GDP, GNP, depreciation and other estimates of national income for one fiscal year.

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2.4 INFLATION

In this section, you will study the meaning of Inflation, different methods of its measurement and how does it affect different sections and dimensions of an economy.

Definition of Inflation

One of the most daunting task before economists is to define Inflation as there are multitudes of problems in penning down one definition. Therefore there is no universal definition for this problem. Many economists have given different definition like according to Coulborn, Inflation can be understood as a situation whereby "too much money chases too few goods". A situation in which the value of money falls and price rises is inflation according to Crowther. These and other definitions have one or another deficiency.

Economists are unanimous that inflation refers to a '*persistent' and 'appreciable'* rise in the general price level. However, the word persistent and appreciable are not clearly defined so there is space for ambiguity. For example, whether the rate of price rise by 1 %, 5 % or 30 % is considerable or there is some other rate which is deemed to be considerable.

The issue of inflation is of utmost importance because it is both boon as well as bane. A rise in prices is necessary for producers to induce them to supply more in the market. But higher prices lead to more burden on the consumer pocket and it may also create many political and social problems. So, what an economy needs is a moderate rate of inflation. This takes us to another question, what is a moderate rate of inflation? The answer to this question varies from country to country depending on the level of development. For instance, in the case of India, a committee set up by the Reserve Bank of India (RBI) to review the monetary system which is popularly known as Chakravarty Committee (1985) recommended that 4 percent rate of Inflation is desirable for India's economic growth.

Different Methods of Measuring Inflation

There are two common methods of measuring inflation.

- Changes in Price Index Number (PIN)
- Gross National Product (GNP) deflator

Changes in Price Index Number (PIN)

The rate of inflation can be estimated by measuring the change in the price index number. The formula for this change is

$$Rate\ of\ Inflation = \frac{PIN_t - PIN_{t-1}}{PIN_{t-1}} * 100$$

PIN_t and PIN_{t-1} are price index number in the current and preceding year

Let us assume that Consumer Price Index (CPI) on March 31, 2020, was 300 and it increased to 320 on March 31, 2021, then the rate of inflation in 2020-21 will be:

$$Rate\ of\ Inflation = \frac{320 - 300}{300} * 100 = 6.6\ \%$$

Consumer Price Index (CPI) and Wholesale Price Index (WPI)are two popular price indexes thatare used to measure inflation. Further in India, CPI has 3 sub-components namely CPI rural, urban and combined.

GNP Deflator

GNP deflator or known as GNP implicit price deflator. As it is not directly obtained like CPI and WPI it is called implicit. It can be obtained by the following formula

$$GNP\ deflator = \frac{Nominal\ GNP}{Real\ GNP} * 100$$

Nominal GNP is the GNP at the prevailing prices and real GNP is at constant prices of the base year.

Out of these two indexes, the GNP deflator is considered to be better because of its broadest coverage.

Different Types of Inflation

The major types of Inflation are:

- Creeping /Moderate Inflation
- Galloping Inflation

- Hyper Inflation

Creeping /Moderate Inflation

Generally, when the rate of inflation is single-digit it is termed as the creeping or moderate rate of inflation. This type of inflation is mostly expected by both consumer and producer and they plan economic activities accordingly.

Galloping Inflation

When inflation is in the double-triple digit range a year it is termed as galloping. This type of inflation erodes the savings of the economy and has a disastrous effect on the fixed income group.

Hyper Inflation

This is one of the most dangerous forms of inflation in which price rise by more than 50 % a month. During this period paper currency losses it value drastically and current note of biggest possible denomination are printed. World history is full of many examples when economies witnessed the episode of hyperinflation. For example in Germany, the wholesale price index increased by 100 million percent between December 1922 and November 1923.

Causes of Inflation

The main causes of inflation are clubbed under two major headings:

- Demand-Pull Inflation
- Cost-Push Inflation

Demand-Pull Inflation

According to demand-pull inflation, the main cause of inflation is the increase in demand or aggregate demand (in Keynesian terms). According to Keynes, aggregate demand consists of four major components i.e. consumption, investment, government expenditure and net exports i.e. $AD = C + I + G + (X - M)$ (this equation we saw in the expenditure method of measuring national income also). If any of the constituent increases then it will lead to an increase in AD and which will further lead to a rise in prices. Similarly, according to Monetarists (a school of thought in economics that gives much importance to monetary factors) increase in money supply leads to an increase in AD. Due to increases in money

supply, more money is given in the hands of the public and they tend to either consume it or invest it and in both situations, AD will increase.

Cost-Push Inflation

The increase in the cost of production is the major cause of cost-push inflation. Whenever the cost of production increases, producer tends to shift the burden of this increase in form of higher prices on to consumers. An increase in money wages due to pressure of trade unions, decrease in the supply of raw material, increase in the prices of inputs like raw materials etc. are some of the major constituents of cost-push inflation.

Effects of Inflation

Inflation affects almost all the economic agents of the economy be it consumer, producer or government. The favourable or unfavourable effect depends upon the rate of inflation. In this section, you will understand how does it impact the distribution of income and wealth, producers, wage earners, borrowers and lenders and some other segments of the economy.

Impact on Income Distribution

How will inflation affect income and wealth distribution depends upon the prices of the output which the producer produces and the prices of the inputs like labour and land. If output prices rise more than input prices, then income will be distributed in the favour of the producer or the profit earner or the employer. The plausible explanation is when the price of output rises, it translates to higher revenue and profit of the producer. So the revenue-wage gap increases and the larger share of the national income goes to the employer. The overall impact is that firm/producer who was already rich they get even richer and the poor (especially labour) get poorer.

Deterioration in the Value of Money

Inflation erodes the purchasing power of money. It implies that the real wages or real income decline with a rise in prices. For example, let us suppose that the price of good X was Rs 10 per piece and you have Rs 500 as your money income. So if you spend your entire income on good X, you could buy 50 units/pieces. Now keeping other things constant the price of good X rise to Rs 20 per piece. Now the same Rs 500 can fetch you only 25 units of X good. So the currency denomination remains the same but its purchasing power reduces. You can buy fewer goods with the same income. This type of effect is most harmful to daily wage earners,

persons with fixed income and employees working in the unorganised sector, as they do not have any safeguard against this price rise.

Impact on Borrowers and Lenders

It is the borrowers who tend to gain due to inflation and lenders lose. Now suppose you are a borrower and you borrow money at the prevailing rate of inflation. Now when you repay the same amount to your lender no doubt you are paying the same amount with the rate of interest but the real value of money has reduced. More specifically you pay less in terms of purchasing power or goods and services. So you(borrower) gain and your lender losses.

Methods of Taming Inflation

Monetary policy is one of the policy option and direct method of controlling inflation. Reserve Bank of India makes use of monetary policy to regulate the supply of credit in the market. The various tools and methods used within the monetary policy are discussed in Unit-5.

Activity 3

1. Read the chapter on Prices and Inflation in the Economic Survey of the current year and analyse the situation of inflation and the major steps undertaken by the government to control the problem.

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2.5 SUMMARY

This unit has given a detailed account of economic growth and development. A clear understanding of the difference between economic growth and development is of paramount importance. The different theories of growth as discussed in the preceding sections has equipped us with ideas as to variables like saving, investment, capital accumulation, human capital are necessary for the economy to achieve higher levels of growth.

Similarly, the unit discussed in detail about GDP and national income and the various methods with which the national income estimates can be calculated. The value added method calculates national income from the production side. Income method combines the factors of income (like wages, rent, interest and profit) along with income received from abroad to arrive at national income figures. The expenditure method takes the route of the expenditure side of the economy to calculate national income.

In the last section of the unit, you have learnt about the meaning of inflation. The different methods of measuring inflation like CPI, WPI and GNP deflator along with various reasons for inflation and the effect of inflation on income distribution, wage earners, fixed income groups, borrowers and lenders.

2.6 KEY WORDS

Gross Domestic Product (GDP): Market value of all final goods and services which are produced by the residents of a country within the domestic territory of a country in a given period of time.

Capital-Output Ratio: The units of capital needed to produce one unit of output.

Per capita Income: It is the total income of the country divided by the total population.

Production Function: It is functional relationship between output and various inputs.

2.7 SELF- ASSESSMENT QUESTIONS

1. Highlight the major assumptions of the Harrod-Domar model of economic growth.
2. What are the major conclusions of the Solow model of economic growth?
3. What are the major ideas of Endogenous growth theory?
4. Differentiate between galloping and hyperinflation?
5. Explain some of the methods of estimating inflation.

2.8 REFERENCES/ FURTHER READINGS

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UNIT 4 BUSINESS ETHICS AND CORPORATE SOCIAL RESPONSIBILITY (CSR)

Objectives

After reading this unit you should be able to:

- define the concept of Business Ethics;
- explain the need for Business Ethics;
- define Corporate Social Responsibility;
- discuss the benefits and drivers of Corporate Social Responsibility (CSR); and
- identify CSR initiatives by the companies.

Structure

4.1 Introduction

4.2 Business Ethics

4.3 Sources of Ethics

4.4 Importance of Business Ethics

4.5 Ethical Issues in Business

4.6 Corporate Governance and Corporate Sustainability

4.7 Corporate Social Responsibility (CSR)

4.8 Benefits of CSR

4.9 Drivers of CSR

4.10 CSR Initiatives in Indian Companies

4.11 Summary

4.12 Key Words

4.13 Self-Assessment Questions

4.14 References/ Further Readings

4.1 INTRODUCTION

For organisations while ensuring growth is important, ensuring that it takes place in an ethical, just and inclusive manner is even more important. They have to also ensure that the conduct of business activities conform to the existing norms of accepted behavior and are run in a socially

responsible manner. Corporate governance plays an important role in the way businesses are directed and controlled.

This unit focuses on the significance of business ethics and corporate governance in business. It discusses the concept and benefits of Corporate Social Responsibility (CSR) and some of the CSR initiatives by the companies.

4.2 BUSINESS ETHICS

Business ethics are a kind of applied ethics. It is the application of moral or ethical norms to business. The term ethics has its origin from the Greek word 'ethos', which means character or custom- the distinguishing character, sentiment, moral nature, or guiding beliefs of a person, group, or institution. Ethics are a set of principles or standards of human conduct that govern the behaviour of individuals or organisations.

Ethics can be defined as the discipline dealing with moral duties and obligations, and explanation regarding what is good or not good for others and for us. Ethics is the study of moral decisions that are made by us in the course of performance of our duties. Ethics is the study of characteristics of morals and it also deals with moral choices that are made in relationship with others. Business ethics comprises the principles and standards that guide behaviour in the conduct of business. Businesses must balance their desire to maximize profits against needs of its stakeholders. Maintaining this balance often requires trade-offs. To address these unique aspects of businesses, rules, articulated and implicit, are developed to guide the businesses to earn profits without harming individuals or society as awhole.

Difference between Ethics and Law

While law is obligatory and violation of law attracts penalties from the justice system, ethics are more voluntary in nature. However, not acting ethically might lead to violation of laws, as most laws are in one way or the other a codification of ethics.

Business ethics can be said to begin where the law ends. Business ethics is primarily concerned with those issues not covered by the law, or where there is no definite consensus on whether something is right or wrong. Business ethics is about the grey areas of business, where values are in conflict. In such scenarios, there might not be a definitive 'right answer'.

4.3 SOURCES OF ETHICS

1. **Genetically imbibed**: Traits like cooperation and selflessness stand centric to the ethical system and it has been witnessed to be carried from one generation to the other.

Schooling focuses on ethics to be core of the child development. This is complemented with the learning from the parents and the society.

2. **Religion**: The acceptance of religion as 'law' has its roots before the onset of the legal system. Psychologically, this belief or faith in the religion which makes people comply to the imposed restrictions to accept any unsolicited behaviour in the society.
3. **Culture**: Culture also drives ethics. Customs, societal norms, traditions and standards get passed on to next generations. Culture varies from one religion to the other but the ethical essence doesn't differ much. Unethical practices are not supported by the culture irrespective of the wide geographical differences.
4. **Philosophical System**: It is culturally initiated to affect ethical conduct of a person or society. There have been many thinking personalities in India who have postulated their experiences for actions into the society. Mahatma Gandhi, Swami Vivekanand, Subhash Chandra Bose, Raja Ram Mohan Roy, Bhagat Singh and Swami Dayanand Saraswati had varied philosophical perspectives which modulated to form and govern the ethical conduct of people from inspiration and learning.
5. **The Legal System**: It has been rightly said that "Laws represent a rough approximation of a society's ethical standards". The prevailing societal evils like hoarding of essential commodities, exorbitant charging, concealing facts, deceiving, falsified statements, etc. amount to unethical behaviour and need to be curbed by necessary formulation, amendment and implementation of a stringent legal framework.
6. **Code of Conduct**: The society plays a crucial role in framing the code of conduct for ethics. The workplace ethics are based on common beliefs and are broader in nature. To further enhance them, the company formulates a framework of operating policies which direct the decision making from the ethical perspective. This framework indicates the ethical decision making in matters pertaining, but not limited to, customer complaint handling, stakeholders, employee and vendor hiring, etc. Besides the organisational level, ethics are framed for a particular industry level also irrespective of the number of companies being served by that industry. For example, the advertising vertical encompasses extending services to various companies and this vertical has formulated 'Indian Association of Advertising Agencies' to develop an ethical code of conduct for

advertising agencies, firms etc. which is to be followed by the concerned professional and industry associations.

4.4 IMPORTANCE OF BUSINESS ETHICS

Now, let us understand why Corporate Ethics matter to business. Ethics matter because ethical conduct is the right conduct. However, in the absence of a time-culture, and context-neutral definition of 'right', it is very difficult to develop a code of conduct on this basis alone. It basically says that businesses avoid many risks and gain reputation by acting in an ethical manner.

A good ethics process, operationalised in such a way that all decision making procedures and structures support it on a day-to-day basis, will give an organisation the best chance possible for finding out about potential problems early so that they can be dealt with before they become a disaster. There are also market advantages to be gained from an ethical reputation.

Ways in which Ethics are Important -

Major scandals such as WorldCom, Enron, Lehman Brothers etc., in the US and Satyam in India tell us why ethical business practices are becoming increasingly important. There are several reasons why ethics are important to business:

- To understand reasons behind increasing influence of corporates in society.
- To ensure that no harm is done to society.
- To meet ethical expectations more effectively.
- To enable companies to identify employee and customer concerns at an early stage.
- To improve the quality of a firm's relationships with its key stakeholders.

The government is interested in ensuring ethical business practices to ensure a basic level of integrity in the market place. This promotes international competitiveness of the economy and improves a country's image concerningease of doing business.

Even domestically, predictable levels of ethical behaviour ensures that costs of business such as transaction costs, hedging and insurance etc., are kept to a minimum.

Unethical behaviour imposes costs on the government and taxpayers. Bad behaviour by a few impacts on all businesses and might also have an adverse impact on the country's international competitiveness.

Ethics can help improve decision making by providing managers with the appropriate knowledge and tools that allow them to correctly identify, diagnose, analyse, and provide solutions to the ethical problems and dilemmas they are confronted with.

Ethics help in analysing the reasons behind this, and the ways in which such problems might be dealt with by managers, and regulators in improving business ethics.

Business ethics can provide us with the ability to assess the benefits and problems associated with different ways of managing ethics in organisations.

Business ethics also equips us with knowledge that goes beyond the traditional boundaries of business studies.

Activity 1

Illustrate a business case in which ethical practices have created a strong public image for the corporate.

4.5 ETHICAL ISSUES IN BUSINESS

You have understood that business has various motives. Some of the motives are: wealth motive, profit motive, societal benefit and overall benefit of shareholders and stakeholders. The dilemma remains between striking the balance between profits and ethics. The organisations practice ethics as it bolsters their goodwill and reputation of being fair, honest and integral both at the business and the corporate level thereby, fortifying their image. Organisations expect the employees at all levels carry this legacy of identity with utmost care. Ethics provide the framework within which the organisation makes ethical investment. Ethical investment is followed in management of investment portfolio which consists of company shares. Profit is an inherent motive of business. But various economic thinkers have propagated various business motives varying from profitability, wealth, utility maximization, etc. But there are differences of opinion too. On the one hand there is the ideology of Karl Marx, according to which it is unethical to do business to accumulate wealth. On the other hand, Mahatma Gandhi believed in business but preached trusteeship according to which a businessman should look after the welfare of his employees.

Let us discuss this further with examples from various companies. In the early 1980s the Indian automobile industry had two leading brands namely the Ambassador from HM and the FIAT. The Japanese entered with Suzuki and Maruti became a household name. Subsequently we saw a lot of foreign brands like the Daewoo, Hyundai, General Motors, Toyota, etc. entering the fray. Each of these multi-national companies had their own management style and ethic orientation. Few worked on vendor relations, Research and Development aiming at cost reduction, while others worked on advertising and creating a robust distribution network. Within all this high level marketing impact the Indica model from the national brand Tata was launched. Though the model didn't compete much with the elite MNC brands but it was able to create a significant presence for the customers who believed in Tata's ethical philosophy. So a low advertised product also garnered a market share as the word of mouth from the customers spread fast thereby creating a brand identity for Tata.

The advantages of being ethical:

1. Preferred by prospective employees and creation of quality talent pool.
2. Less number of employees leaving the organisation i.e lower attrition rate.
3. Less number of employee strike or labour unrest.
4. Corporate goodwill enables bargaining power which results in cost reduction →increase in production→ achieving economies of scale→ more revenue and profits→ longer business viability.

Activity 2

Study the business ethics of any two leading conglomerates and mention which one, according to you, is more ethic centric and why? Support your answer with relevant examples.

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4.6 CORPORATE GOVERNANCE AND CORPORATE SUSTAINABILITY

To influence the corporate path to sustainable development, following approaches are advocated namely:

- The Triple Bottom Line Approach (People, planet and profits), 1995
- United Nations Global Compact (UNGC), 1999
- OECD (1999) – guidelines are addressed to MNCs
- ISO Standards
- Global Reporting Initiative, 1997 – guidelines are for all organisations.
- Sustainable Development Goal, 2015
- World Bank GRI Index, 2020 – World Bank sustainability disclosure index prepared with core option of the GRI standards.

In addition to the Triple Bottom Line approach which originated from Elkington's the planet-people- profit (environmental, social and economic) framework. Elkington argued business can be sustained by fulfilling stakeholders' interest, environmental protection policies and public welfare.

Global Reporting Initiative (GRI) is an international organisation founded in 1997. GRI has its roots in the US not for profit organisations, the coalition for Environmentally Responsible Economies. United Nations Environmental Programme (UNEP) was involved in the establishment of GRI. GRI enjoys strategic partnership with Organisation for Economic Corporation and Development (OECD), the UN Global Compact, United Nations Environmental Programme (UNEP) and International Organisation for Standardisation (ISO). GRI has designed the world's standard guidelines in sustainability reporting. GRI's mission is to make sustainability reporting a standard practice and to enable all companies and organisations to report their performance on the following criteria: 1) Economic, 2) Environmental, 3) Social and 4) Governance.

The G3 is "Third Generation" of the GRI's sustainability Reporting guidelines launched in 2006. G3 reports only on impact study. G4 reports on broader aspect of impact study which includes general standard disclosure on organisation profile, stakeholder and governance. Global

Reporting Initiative includes governance criteria in addition to the Triple Bottom Line, economic, social and environmental criteria.

The **Organisation for Economic Cooperation and Development (OECD)**, in 1999, defined Corporate Governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders, and should facilitate effective monitoring thereby encouraging firms to use recourses more efficiently."

The **purview** of Corporate Governance includes:

1. ***Rights of and equitable treatment of shareholders***: Organisations should respect the rights of shareholders and help shareholders exercise those rights.
2. ***Interests of other stakeholders***: Organisations should recognise that they have legal and other obligations to all legitimate stakeholders.
3. ***Role and responsibilities of the board***: The board needs a range of skills and understanding to be able to deal with various business issues and to have the ability to review and challenge management performance. It needs to be sufficiently sized and have an appropriate level of commitment to fulfill its responsibilities and duties.
4. ***Integrity and ethical behaviour***: Organisations should develop a code of conduct for their directors and executives that promote ethical and responsible decision-making.
5. ***Disclosure and transparency***: Organisations should clarify the role of the board and the management and the same should be conveyed to the public. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of financial matters concerning the organisation should be timely and balanced to ensure that all investors have access to clear, factual information. Transparency is the best principle of corporate governance.

Role of Corporate Governance

You would have understood that the role of corporate governance is largely significant to the society and impacts various internal and external stakeholders. Corporate Governance aims at the following aspects:

a) It fosters an efficient use of resources and curtails wastages.
b) It aims at resource allocation to those verticals for bringing in efficiencies in the production of goods and services which further generates interest of the shareholders.
c) It chooses best effective managers to manage scarce resources to derive optimal results.
d) It enables the managers to remain attentive and focused for enhanced performance continuously.
e) It brings in investor's attractiveness and also increases the shareholders' value.
f) It fosters increased consumer satisfaction which aids in growing market share, besides the sales.
g) It results in higher employee satisfaction, low turnover rate and lower HR costs. Further, satisfied employees bring customer satisfaction.
h) It also attracts vendors and brings an efficient inventory management system with reduced purchase/production costs.
i) It brings down the marketing costs by developing good rapport with the channel partners, distributors, etc.

4.7 CORPORATE SOCIAL RESPONSIBILITY (CSR)

The CSR has become one of the standard business practices of our time. For companies, the overall aim of CSR is to have a positive impact on society as a whole while it engages in maximizing the creation of shared value for the owners of the business, its employees, shareholders and stakeholders. "Corporate Social Responsibility is a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders. CSR is generally understood as being the way through which a company achieves a balance of economic, environmental and social imperatives ('Triple-Bottom-Line-Approach'), while at the same time addressing the expectations of shareholders and stakeholders" (UNIDO).

The initial definition of CSR was given by Horward R Bowen who defines CSR as "Obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society".

In the 1960s, one of the most prominent definitions of CSR was given by Keith Davis who defines social responsibility as "businessmen's decisions and actions taken for reasons at least partially beyond the firm's direct economic or technical interest".

The concept of CSR evolved and extended to beyond economic and legal components to encompass ethical and voluntary aspects as well. Caroll in 1979 gave a definition containing all four components. "The social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organisations at a given point in time".

Corporate Social Responsibility (CSR) in its essence fosters the business accountability from the stakeholder, shareholder and investor perspective which may include factors such as environmental protection, care for employees, the society and public at large not only in the present context but in future too. It is a result of continuous interaction between the business and the society.

Regulatory Mechanism for CSR

With the enactment of Section 135 of the Companies Act 2013, India became the first country to make CSR spending and disclosure mandatory for large companies with specific turnovers.

The Companies Act 2013 and CSR

The inclusion of the CSR mandate under the Companies Act, 2013 is an attempt to supplement the government's efforts of equitably delivering the benefits of growth and to engage the Corporate World with the country's development agenda. The Companies in India are governed by Clause 135 of the Companies Act 2013for performing their CSR activities.

Section 135

Section 135 of the Companies Act 2013 lays down that:

- The companies with an annual turnover of 1,000 crore INR and more, or a net worth of 500 crore INR and more, or a net profit of 5 crore INR and more shall constitute a CSR Committee of the Board consisting of 3 or more directors of which one will be an independent director.

- The CSR Committee will be responsible to
  i) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;

ii) recommend the amount of expenditure to be incurred on the activities referred to in (i); and

iii) monitor the Corporate Social Responsibility Policy of the company from time to time.

... The Board of every company shall

i) after taking into account the recommendations made by the Corporate Social Responsibility Committee, approve the Corporate Social Responsibility Policy for the company and disclose contents of such Policy in its report and place it on the company's website, if any, in such manner as may be prescribed; and

ii) ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company.

- It is also the duty of the Board to ensure that the company spends two percent of the average net profits made by the company in the preceding three financial years and while spending the CSR amount giving preference to local areas where it operates.
- If the company fails to spend the amount, the Board in its report shall specify the reasons for not spending the same.

Though section 135 makes CSR spending and reporting mandatory, it gives flexibility to the companies to choose the CSR activities from the list of activities that the corporate can potentially undertake.

Source: mca.gov.in

Companies Amendment Act, 2019- Section 135.

Any amount unspent shall be transferred within 30 days to special account in scheduled bank and spent within 3 financial years.

For company- if company contravenes the company shall be punishable with a fine of 50,000 INR - to 25 lakhs INR.

For officer- Who are defiant are punishable with imprisonment for a term which can extend to three years or fine of 50,000 INR - 5 lakhs INR or with both.

CSR and Shareholders

Shareholders are one of the important pillars who not only invest in the company's business but also remain associated with the financial returns in the form of profits and/or dividends. This makes companies work for shareholder's return thus increasing transparency, giving handsome returns and enabling them in decision making enhances the shareholder's role in the company towards wealth maximisation. This is not one time but a continuous effort. Important to understand here is that shareholders are one of the societal stakeholders too.

CSR and Employees

The employees also are the internal customers of the organisation and the business's success is dependent on the employees. With changing times, the employees have become an important contributory factor towards the attainment of organisational objectives. Organisations have realized their responsibilities, towards them, thereby ensuring the following:

1. Equal opportunity. Grievance Redressal Mechanism.
2. Fair wages, a transparent performance appraisal system, clear work instructions and work environments and work policies.
3. Hygienic, safe and congenial working environment.
4. Setting up of labour benefit and welfare amenities.
5. Employee recognition and career growth.
6. Skill enhancement and participation in organisational decision making.
7. Employee Engagement is one of the prominent factors in organisations.

CSR and the Consumer

1. Company offering quality products and meeting regulatory standards.
2. Customer oriented approach leading to more R&D focus and innovative products.
3. Ensure supplies at equitable prices and provide due after-sale services. This includes the availability of spares and service facility to the customer.
4. All safety norms are followed to ensure safety of the customer.
5. Consumer grievances are addressed on priority basis.

CSR and Community Participation

1. Environmental pollution control and ecological concerns.
2. Enhanced R&D to product regulatory standards.
3. Economic development and improvement of backward areas mainly by the development of small scale businesses and community services.
4. Social initiatives like basic and primary education, social responsiveness initiatives like women empowerment and adult education, healthcare and related medical amenities.
5. Conservation of limited and scarce resources thereby proposing environment friendly solutions like bio-gas, LPG and solar power.
6. Environmental concerns like natural calamities, the role of CSR to the community increases manifold by putting in measures like adopting curative and preventive measures for controlling epidemic, cleanliness and other hygiene issues.

Advantages of CSR

Various advantages of CSR initiatives are:

1. Citizens expect that the companies will support them in societal upliftment.
2. CSR activities contribute in local and regional development.
3. A regularly supportive and conducive behaviour enable the company earn a goodwill and rapport which helps in image building.
4. CSR initiatives like rain water harvesting, enabling educational, legal and health infrastructure, etc. creates an enabling and supportive environment.
5. A periodic update to the government by the company contributes towards reputation building.
6. There may be social concerns which might have remained unaddressed by the government and social institutions, which may be resolved by the corporate intervention through CSR.
7. CSR initiatives may promote businesses within the vicinity of the companies whose products and services are required in fulfilling the CSR tasks.

Disadvantages of CSR

1. The cost incurred on economic social and environmental initiatives under CSR curtails the company of funds for deployment at other business verticals.
2. The share of profit to the shareholders is also impacted by the CSR activities.
3. Such social works need the expertise of management personnel who have to manage time between priority and non-priority areas.
4. Time spent on CSR could have been utilized on other economic and developmental activities.
5. Since CSR is an added responsibility to business, the existing manpower needs to be trained and developed to serve the societal expectations.
6. Businesses pursue CSR activities out of their given allocation of resources and capital for situations which demand prioritised business attention thereby redirecting the socially earmarked resources.

Activity 3

Enumerate various CSR activities taken by an Indian business conglomerate of your choice. Which one according to you is the most mutually beneficial? Why?

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4.8 BENEFITS OF CSR

Businesses these days can no longer limit their focus to profit maximization and be satisfied just by creating employment and paying their taxes. They are also required to address the needs of other stakeholders like creditors, employees, shareholders, consumers, government and public.

Companies these days are more vulnerable to consumer boycotts and campaigns. The companies need to be socially accountable to the communities among whom they operate. Hence, CSR as a strategy and in fact as a necessary activity, is becoming increasingly important for businesses due to the following benefits: (CII, 2013)

Communities provide the license to operate: The CSR behaviour of corporate is not just driven by their values but are also influenced by the stakeholders like government, investors, customers and community. Todays corporate understands that the license to operate in any particular area is not just given by the government but also by the communities that get impacted by the activities of these companies. A strong CSR programme provides the companies with the license to operate and to maintain the trustof the local community.

Attracting and retaining employees: CSR interventions that help the employees to participate give them a sense of belongingness to the company. Good CSR initiatives can attract employees to the company and give them the incentive to remain motivated and committed to the company.

Communities as suppliers: There are instances wherein as a part of CSR activities, the communities have been incorporated into the supply chain to enhance their livelihood. Such initiatives have helped in increasing their incomes and ensuring the companies with a steady and secure supply chain.

Enhancing corporate reputation: When the companies position themselves as responsible corporate citizens, it creates good will and a positive image, thereby helping them to enhance their brand image in the market.

4.9 DRIVERS OF CSR

According to the KPMG Survey of Corporate Responsibility Reporting 2011, around the world, corporate responsibility reporting has become a fundamental imperative for businesses. According to the KPMG survey, the top ten motivators driving corporations to engage in CSR for competitive reasons, the following have emerged:

- Economic considerations
- Ethical considerations
- Innovation and learning
- Employee motivation
- Risk management or risk reduction
- Access to capital or increased shareholder value
- Reputation or brand
- Market position or share
- Strengthened supplier relationships

- Cost saving

In simple words, the underlying reasons for business organisations to be involved in CSR are as follows:

Public Image

CSR creates a positive brand image in the minds of the potential consumers. Effective communication of CSR activities boosts the purchase intentions of the prospective consumers. Business can earn goodwill and reputation by performing the activities towards the welfare of the society. People prefer to purchase products of the company that engage in various social welfare programs.

For example: Levi Strauss practices CSR in three areas i.e. the masses, climate, and its products. It's non-profit Red Tab Foundation provides aid to its employees and retirees in case of financial emergency. As a part of its contribution to the environment, it has signed the Climate Declaration and aims to use 100 percent renewable energy in order to reduce carbon emissions and other greenhouse gases. In addition, in a bid to save water, it has started production of its new denim cloth-line which has helped them save more than 1 billion litres of water since its inception in 2011.

Government Regulation

Most companies prefer to remain a step ahead of government regulations in identifying the social needs and formulating policies to address them, out of the fear that if they don't, the government may take the responsibility, which might prove costly for the employers. To avoid government regulations businessmen should discharge their duties voluntarily.

For example, **Coca-Cola, USA** continues to make strides towards the alleviation of environmental issues. After realizing that its fleet of delivery trucks accounted for 3.7 million metric tons of greenhouse gases (GHGs) in 2014, Coca-Cola made significant changes to its supply chain like investing in trucks that are powered by alternative fuels. Those changes should support the company's goal of reducing its carbon footprint by25 percent by 2020.

Survival and Growth

Every business is a part of society. It utilizes the available resources of power, land, water etc. of the society, therefore it should be the responsibility of every business to spend a part of its profit for the welfare of the society.

For example, **Amul Dairy** has launched a novel scheme "Rural Sanitation Campaign" for total rural sanitation. The dairy with the support of **District Rural Development Agency** (DRDA) will provide interest free loans to its milk producers in the districts of Anand and Kheda, to set up

'pucca' toilet blocks, which will not only help women milk producers avoid embarrassment but will ensure hygiene as well.

(For more details visit http://www.amuldairy.com/index.php/component/content/category/13-csr- initiatives)

Employee Satisfaction

Besides getting good salary and working in healthy atmosphere, employees also expect other facilities like proper accommodation, transportation, education, and training.

For example, **Lemon Tree Hotels Group** ('LTH') believes that people with disabilities (whether physical, social or economic disabilities leading to an opportunity deprivation) must be provided the same opportunities as others to realize their full potential and live with dignity. Lemon Tree has defined the goal as mainstreaming 'Opportunity Deprived Indians' i.e. ODIs into its workforce. By creating a supportive environment in the organisation that allows them to deliver their best, LTH helps in bringing social inclusiveness through livelihood creation. (For more details visit https:// www.lemontreehotels.com/factsheet/LTH_CSR_Policy.pdf)

Consumer Awareness

Nowadays consumers have become very conscious about their rights. They protest the supply of inferior and harmful products by forming different groups. This has made it obligatory for businesses to protect the interest of the consumers by providing quality products at competitive prices.

For example, **Burberry** announced banning fur in its products along with other ladies' bag manufacturing companies like Gucci, Versace, Armani, Stella McCartney and others after a long campaign from the animal rights group PETA.

4.10 CSR INITIATIVES IN INDIAN COMPANIES

Some of the CSR initiatives of Indian companies are listed below:

Tata Chemicals Ltd.

Tata Chemicals Ltd. has spent 25.68 crores for CSR in 2018-2019 which was much higher than the prescribed amount of 19.86 crores. Improving the quality of life and fostering sustainable and integrated development in the communities where it operates is central to Tata Chemicals' corporate philosophy. In order to do so Tata Chemicals established Tata Chemicals Society for Rural Development (TCSRD) in 1980 as a society and trust. It lays emphasis on the spirit of participatory development by involving the beneficiaries at each stage of the development process

which ensures viability and sustainability of the programmes (Fernandes, 2019). Around 30 percent of the TCSRD funds are spent on wildlife conservation. The amount is distributed over three places the company operates - Mithapur in Gujarat, Haldia in West Bengal and Babrala in Uttar Pradesh.

Infosys Ltd.

Infosys Limited had established the Infosys foundation in 1996 to implement its social development projects. During 2019, the company had spent INR 342 crores against the prescribed 340 crores towards various CSR schemes. The major works of the Foundation included the introduction of Aarohan Social Innovation Awards, restoration of water bodies in Karnataka, supporting the construction of a metro station in partnership with Bangalore Metro Rail Corporation Limited, enabling the pursuit of access and excellence in sports through the GoSports Foundation, and relief efforts in Tamil Nadu, Karnataka, and Kerala (Fernandes, 2019).

Bharat Petroleum Corporation Ltd.

BPCL as a part of its CSR initiatives, focuses on imparting holistic education by facilitating usage of technology and infrastructural facilities. Additionally, BPCL's CSR philosophy also includes participation in projects of national importance like the Swachh Bharat Abhiyan involving creation and maintenance of toilets, associated sanitation facilities, waste management initiatives leading to overall health and hygiene for the communities.

Mahindra & Mahindra Ltd.

Among the various development programmes supported by Mahindra and Mahindra Ltd. are Nanhi Kali programme to provide educational support to underprivileged girls in India. It sponsors Lifeline Express (hospital on train) to provide medical care, treatment, and surgical intervention to individuals. Through Mahindra Hariyali 0.95 million trees were planted which contributed to improving green cover and protecting bio-diversity in the country.

Vedanta Ltd.

The CSR portfolio of Vedanta Ltd. has diverse projects based on 10 broad thematic areas running across various locations. The Nandghar project is the flagship initiative which aims at rebuilding Anganwadis to ensure health and learning of children in rural areas and for skilling and empowering women.

Indian Oil Corporation Ltd.

Indian Oil Co. Ltd. has been involved in various social development activities across the nation. Most of these projects are for improving the quality of life of the marginalized and underprivileged sections of the society. The key thrust areas of the company include Safe drinking water and protection of water resources, Healthcare and sanitation, Education and employment-

enhancing vocational skills, Empowerment of women and socially/economically backward groups.

Hindustan Unilever Ltd.

Hindustan Unilever Limited (HUL) believes in long term sustainable growth achieved by reducing environmental footprints and increasing its positive social impact. The various CSR programmes of the company include Handwashing Behaviour Change Programme, Plastic Waste Management, Project Prabhat, Water Conservation Project, Swachh Aadat Swachh Bharat, Project Shakti, Domex Toilet Academy, Asha Daan, Sanjeevani and Supporting Healthcare.

4.11 SUMMARY

Business ethics discusses the extent of exhibited behaviour (correct or incorrect) on moral standards rather than banking on the financial and operational management perspective only. The defined ethical framework in decision making is sought in conducting smooth business operations.

Business has deep ramifications to the natural environment and they must be resolved on moral grounds. The case of the Korean conglomerate Posco's investment plans in Orissa is the relevant example of such concern which not only involves morality but social and legal aspects too.

Corporate governance has been witnessed garnering attraction by the society of its virtue to address company's profitability from shareholder's perspective, as well as societal advantages. An organisation exhibiting higher standards of the corporate governance becomes benchmark for others to follow and builds investors' faith and confidence resulting in financial prosperity of the organisation.

The concept of Corporate Social Responsibility (CSR) has evolved from being voluntary practices to regulatory mechanism. CSR helps in building brand image, attaining competitive advantages and facilitates long term business interest. CSR is growing in terms of its importance and recognition across the globe where small, medium sized and large companies are adopting CSR guidelines to make effective social contributions.

4.12 KEY WORDS

Business Ethics: comprises the principles and standards that guide behavior in the conduct of business.

Corporate Governance: represents the value framework, the ethical framework and moral framework under which business decisions are taken.

Corporate Social Responsibility (CSR): an obligation of businesses to invest for social good in the societies in which they operate and earn their profits.

Drivers of CSR: factors that encourage companies to be more socially responsible.

4.13 SELF-ASSESSMENT QUESTIONS

1. What do understand by the term business ethics? Discuss the importance of business ethics to business citing examples.
2. Define Corporate Social Responsibility (CSR) and discuss the benefits of CSR.
3. Discuss the key motivating factors driving organisations to engage in CSR activities.
4. Write a detailed note on the CSR initiatives undertaken by Indian companies.

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UNIT 3 SOCIO-CULTURAL AND POLITICO-LEGAL ENVIRONMENT

Objectives

After reading this unit you should be able to:

- describe the social and cultural environment;
- identify the elements of socio-cultural environment;
- analyse the recent changes in socio-cultural environment;
- describe the political and legal environment;
- identify the elements of politico-legal environment; and
- understand the recent changes in politico-legal environment.

Structure

3.1 Introduction

3.2 Social Environment

3.3 Elements of Social Environment

3.4 Cultural Environment

3.5 Elements of Cultural Environment

3.6 Political Environment

3.7 Elements of Political Environment

3.8 Legal Environment

3.9 Elements of Legal Environment

3.10 Government Framework for Promoting Business

3.11 Understanding the Legal Environment of Business

3.12 Summary

3.13 Key Words

3.14 Self- Assessment Questions

3.15 References/ Further Readings

ignou THE PEOPLE'S UNIVERSITY

3.1 INTRODUCTION

Every economy has certain kind of environmental surroundings within which every organisation functions. This environment is termed as the business environment. This environment exists for each and every organisation, whether commercial or non-commercial. There are several factors which constitute the business environment. These factors are social, economic, technological, cultural, political, legal and environmental factors. This unit deals with the socio-cultural and politico-legal environment and the different elements influencing these environments. The business environment is not stagnant and keeps evolving. Therefore, it is important to monitor the changing events in the environment on a continuous basis. The unit discusses the impact of these environments on business and economy along with the present changes affecting the social, cultural, legal and political environment.

3.2 SOCIAL ENVIRONMENT

Businesses operate in a society thus their continuous interaction with the society is natural. Businesses require the support from the society in terms of manpower, capital, facilities, etc. while the businesses owe to fulfill their obligations back to the society as they have a social purpose. This in-turn enables them fulfill their responsibility and obligations towards the society as per their accepted levels of social commitment. This becomes an integral part of operating the business for a businessman and thus the understanding of the social environment of business becomes imperative.

Social environment is one of the elements of macro environment of the business. Social environment comprises of social institutions, relationships, beliefs and social structure of the society. In terms of business, social environment of an organisation includes the social values of the workforce along with the society within which the organisation functions. It consists of all the beliefs, customs and practices followed in the society. A business operating within the parameters of a society has to deal with the distinctive values and customs which formulate the factors of social environment affecting a business organisation. In case of a country like India, with diverse cultural backgrounds, the social environment becomes more complex. The social factors are usually influenced by family, friends, co-workers and even the social media. Proliferation of social media influence in present day modern life has increased the perimeter of social environment.

3.3. ELEMENTS OF SOCIAL ENVIRONMENT

Let us identify the various critical elements of social environment and the reciprocal relationship between the business and the society.

- Social problems, prospects, social institutions and systems along with their social values and attitudes.
- Education and culture and their impact on Social groups and activities.
- Socio-economic order and corresponding role and responsibilities of the Government.

Though the above list is suggestive, not exhaustive but it enables you to identify the socio-cultural environment of business.

Let us now discuss the different elements of the social environment.

Attitudes and Beliefs

Attitudes are the perception which people have towards certain situations or commodities. Attitudes are primarily formed on the values and beliefs of a person. Consumer attitudes towards a product or service can influence the demand and supply of that particular product or service. For example, favourable attitude towards a low sugar diet has led to increased demand for sugar free products in the market. This shows that the attitudes and beliefs of people have an impact on the social environment.

Social Class

Each society has a certain extent of social and economic inequality. Social inequality deals with the discrimination based on caste in a society. The caste system in India resulted in social differentiation and has created a difference in the number of opportunities available to people. In other words, social class signified the social status of an individual. Consumer choices differ on the basis of their social status. Another way of class distribution is based on the wealth and income of the individuals and are divided into lower class, lower middle class, upper middle class and upper class. The lower class is considered to have the least earning and upper class is considered to have the most earnings amongst all. These income groups often coincide with the social status of an individual. For instance, people belonging to higher income group usually have a higher social status and vice versa.

Lifestyle

Adopted lifestyle is another element which affects the attitude and behavior of the people. Lifestyle is fundamentally concerned with how the people live and spend their money. The lifestyle pattern has changed in the recent times. People are opting for more simplified and natural ways of life. The awareness towards sustainable practices has changed the way of life. With the pandemic this practice has become all the more prevalent.

Preferences

Preferences are the personal taste of individuals about a product or service. These preferences are directed by other social elements such as friends, neighbours, family, education and income. The preferences change with time. This is correlated with the change in the income status thereby the shift in the lifestyle of people. If we go back few decades back then TV was considered to be a luxury and now it is considered to be a necessity. The preferences result in a dynamic shift for a social environment.

Social Communities

Social communities include the circle of friends and co-workers. The need of social belongingness compels an individual to adhere to practices followed amongst the community members. In many cases people decide upon purchasing a product based on the reviews of his/her social circle. The social community in which the individual lives has a great impact on his/her decisions be it the buying behavior, lifestyle status, education, etc.

Social Institutions

Social institutions refer to social structures in a society under which an individual assumes certain roles for the fulfillment of social needs. People under these social institutions are required to follow certain norms and beliefs. There are five kinds of social institutions namely family, economics, religion, education and government. They are referred to as primary institutions which are further divided into secondary level institutions. Family gives rise to secondary institution as marriage and divorce. Hierarchical structure of a family affects an individual's choice of goods and services. Further, secondary institutions of economics are property, trading, credit banking, etc. The secondary institutions also consider temples, churches, mosques, etc. on the basis of religion.

Education and Culture

Education and culture is another important element of social environment. You also would agree to the statement that the percolation of education has gained foothold and this may be attributed to the increasingly positive attitude towards education, especially from the rural areas. Age-old education, made way to technical or skill based education and then to the structured business

education. All were poised to increase the employment opportunities aiming at increased manpower utilisation arising from a meaningful industry interaction.

Role of Government

Yet another important contributory element is the government and its role as 'a welfare state'. It is an 'apex social institution' and carries much importance in a democratic set-up where it is assumed to be maintaining social order and harmony in the society. Business organisations and Government play a complementary role. In pursuit of performance driven cultures, organisations strive to bring in social cohesion. So terms like consumerism, trade unionism, the cooperative movement, professional management, and shareholders' associations, etc. become the associated keywords for the social business environment.

Activity 1

a. Having understood business environment in the social context, you visit a business organisation in your vicinity and identify the various social groups active there.

b. Enlist various social environment factors detailing how they have impacted your purchase decision?

3.4 CULTURAL ENVIRONMENT

Culture is a range of human actions which are socially transmittable. Culture can be explained as a complex combination of morals, customs, law, art, beliefs, knowledge and habits acquired by any individual member of a society. Culture is embedded in the way of life. In other words,

Culture is a product of social interaction among humans and determines the human behavior. Cultural environment is concerned with the culture within which the organisation operates and includes the culture of its target market and the workforce.

3.5 ELEMENTS OF CULTURAL ENVIRONMENT

Cultural environment contains a number of important elements.

Knowledge and Beliefs

Knowledge and beliefs deal with the pre-existing concepts and philosophies possessed by an individual about his or her surrounding reality. They consist of myths, philosophical thoughts, abstract concepts as well as scientific facts. It is often witnessed that people belonging to a specific culture have set beliefs about a particular thing apart from those permissible within that culture and this may result in not accepting the other view point.

Religion

Religion is an important element of cultural environment. People belonging to different religions have different religious principles, beliefs, thoughts, customs, rituals and traditions. A business organisation should take into consideration every aspect of religious sentiments while marketing their products.

Language

India has a vast number of languages and dialects out of which 22 are officially recognized languages as per the Government of India. Apart from these officially recognized languages, there are regional languages which are spoken within communities only. Variances in the language can be a major concern for business organisation. Different words have different meanings in different languages. This can be extremely crucial before deciding upon a brand name in foreign country. Beyond words, non-verbal communications can also create issues for an organisation. Body language such as gesture and posture has different meanings across different cultures. A same symbol may have different interpretation in different nations or different regions of a country. Verbal or non-verbal language, both have an impact on the overall cultural environment.

Ethnicity

Ethnicity refers to the fact of belonging to a particular cultural tradition. An ethnic group's domination in an area can influence the decisions and strategies of the local businesses operating in that area. Such domination can also influence the choice of trade opportunities. In case of

international markets, ethnicity plays a bigger role. For example, Indian citizens belonging to different cultures within the country belong to a single national ethnicity are referred to as Indians.

Evaluation of Socio-Cultural Environment

Socio-cultural elements are one of the most important factors of the business environment which can influence the managerial decision-making process and strategic goals of a business organisation. Business organisations do not exist in a vacuum. Each and every firm in the industry is surrounded by an environment. Changes in the factors of social and cultural environment can have an effect on the commercial activities across the nations. In other words, shifts in the social and cultural elements of the environment can lead to fluctuations in the demand and supply of an economy. In order to survive in the market a business organisation needs to adapt to the shifts of socio-cultural environment.

The earlier concept of business was limited to profit-making. However, in recent times business is seen as a societal institution working for the betterment of society. Business organisations are considered to be an integral part of the social systems. These businesses have the capacity to influence the life styles of their consumers and the way society works.

Likewise, preferences and attitudes of the people can also influence the business strategies. For example, rising health concerns amongst individuals has resulted in option for a healthy diet. This has forced the organisations to be more cautious about the quality and choice of the ingredients they use in their products. Change in income and education level leads to fluctuations in demand for products and service. A rise in income level led to increased demand for high-end products. For instance, people earning more generally prefer to buy more expensive range of FMCG products as compared to low price brands.

Cultural dynamics also affects the functioning of the business organisations, internally as well as externally. Culture affects many things in an organisation such as pace of business, decision – making and negotiations, employee management, risk-taking capacity and sales and marketing. Culture is responsible for developing trust amongst employer and employees as well as between organisation and its consumers. For example, in India one of the Food and Beverages Company has to customize its menu as per the customs and traditions of the consumers.

A prime example of effect of socio-cultural environment on business can be seen in the promotional campaigns during festive seasons. The campaigns show families celebrating festivals together as a part of their cultural traditions and how the product or service fit into their traditions.

Current Scenario of Socio-Cultural Environment

Change in Fashion Trends

Fashion trends changes every few years. What might be popular ten years ago might not be popular today. Social media influence has rapidly increased the pace of changes in trends. Such changes lead to shift in consumer preferences and attitudes. For instance, clothing brands has to be aware of most recent fashion trends while launching new collection. Another example of this can be change in advertising patterns. Television and print media were considered to be the most popular method of promoting products in the past decade. However, with a rise in users of smart phones and social networking sites, advertising through social media has been a new rage in the field of marketing (Quain, 2019).

Social Issues

Socio-cultural elements not only impact the business strategies of an organisation but also affect the internal policies of the organisation. Raising concern around gender issues has forced organisations to incorporate equal policies and practices for male and female employees. For instance, flexibility in gender roles among husband and wife has led to creation of policies for paternity leave alongside maternity leave. Further, awareness about gender sensitivity has led to change in attitudes towards workplace harassment and gender discrimination. Another instance of such cultural changes is non-resistance towards racial discrimination at workplace (Quain, 2019).

Population

Rise in population in India has resulted in the constant need of urbanization. About one third of the population in India lives in urban areas. India has seen a constant rise in the number of urban population (O'Neill, 2021). Rapid growth in urbanization strengthened the need for urban infrastructure such as transportation, hospitals, schools, sanitation facilities and power supply. A major concern behind the rise in urbanization is migration of population due to industrialization. Moreover, India has major portion of working-age population or young population. This construct has created a labour class at cheap rates. Besides, this young population has created demands for digitized economy. Urban working professional are more interested in digital banking and saving options (UK Essays, 2018).

Multi-Diversity

In present times, a majority of the organisations have a mixed culture workforce, especially in case of multinational organisation. India is a multi-diversity nation with mixed culture race. In order to deal with people from different cultures one must be careful about their business practices, communication style and management style as they might vary among different

cultures. For targeting a consumer segment from other culture, an organisation must keep aside preconceived notions and put in efforts to learn about them (Saylor Academy, 2012).

Activity 2

The socio-cultural environment has been affecting our business. Explain how Mc Donald's food chain has modified its product portfolio to match the socio-cultural environment of India.

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3.6 POLITICAL ENVIRONMENT

You understand that Business, though by its very nature is an economic activity, but the business managers, in order to stay effective, have to consider the non-economic environment of the business too. In this direction, we have understood the socio-cultural environmental component in the previous part of this unit. Here, we would understand another important component i.e. the politico-legal environment of business.

A political system is assumed to be having the qualitative prerequisites such as being stable, honest, efficient and dynamic. Democracy brings in the political participation of the citizens thereby providing them personal security which in-turn contributes for growth of any business in a country. In a political system the role of Government as a political institution is to formulate social policies aimed to deliver on high social benefits at minimum social costs. The government thus facilitates business by making decisions and supporting the economic activity in form of health, infrastructure, education, law and order etc. implemented on different levels like local, regional, national or international.

The political environment comprises of many political factors which effect the business activities at various times and impact, like the bureaucracy levels, corruption, freedom of media and press, tariffs and related measures of trade control, employment regulation, environmental and pollution control laws, health and social safety laws, Competition regulation and cartelization, Tax policy (tax rates and incentives), Trade unionism and related laws, consumerism, e-commerce and related laws about the quality and quantity of the product, Intellectual property law (Copyright, patents etc.). All this is done based on the ideology of the political party forming

the government which attains it by formulating and executing them under a set of policies and programmes. This is attained through legislations and enactments, rules and regulations, systems and procedures, policies and plans, statements and announcements, directives and guidelines by the Government, which is the essence of the politico-legal environment.

Political environment of a country comprises of three elements viz. legislature, executive and judiciary. Political scenario of a country decides the economic policies and trade regulations. Hence, political environment of a country can be crucial for the business operations. Most of the economic reforms are the reason of some political decisions. For instance, prior to 1991 economic reforms, India followed a socialist economic policy approach which was driven by public sector dominated development strategies. However, 1991 economic reforms introduced the concept of private players in the market. In the recent times, the government has allowed 100% FDIs in most of the sectors which has resulted in foreign companies investing more in India markets.

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3.7 ELEMENTS OF POLITICAL ENVIRONMENT

Let us identify the crucial elements of political environment.

Political Ideologies

Political ideologies are the mix of multifaceted ideas, philosophies and objectives which is the foundation of the political parties. Most of the political organisations are politically diverse due to the members of organisation having diverse backgrounds. Political ideologies can differ due to multi-culture environment in the country. People belonging to different social groups, ethnicities, communities, economic class or religion can have different ideologies. These variations impact people to join or support different political parties. Harmony among different political ideologies is necessary to maintain peace and stability within a country.

Democracy

Democracy has been a fundamental part of India's progress and growth story and has helped in binding people from different cultural background and regions. A democratic environment ensures equal political and legal rights to each and every citizen of a nation. It ensures freedom of speech, expression and opinion. Since every citizen cannot decide for himself / herself therefore, countries practice a system of elected representatives. The elected representatives formulate laws for a nation. These representatives are elected by the people of the nation. Democracy also ensures a fair and independent judiciary.

Civil Liberties

Civil liberties ensure the provision of freedom and fundamental rights to every citizen. These include freedom to press, equality before law, personal and social freedom and freedom from biased government policies. Countries with high civil liberties are considered to be free and are more preferred by companies for investments. More liberal countries ensure fair judicial trials in case of disputes and hence are preferred by business organisations.

International Political Relations

Political relations and diplomacy with foreign nations results in more avenues for trade and business which in turn creates multi-lateral or bilateral trade opportunities. For example, trade pacts between USA and India have resulted in several development opportunities for both the nations. Political friendship among different nations creates a favourable environment for international trade and commerce.

Political Stability

Political stability is crucial for growth and development of any economy. Political instability can hinder the flow of foreign capital and adversely affects foreign investment in the country. For instance, clashes between two groups in a region can cause adverse effects on the economic activities in that area.

Government Policy

Stable policies are better for planning corporate strategies and building-up confidence in the industry. Policies formulated with clear directions can support better economic development.

3.8 LEGAL ENVIRONMENT

Legal environment of any country deals with rules, regulations, policies and the law of the land as whole. These laws are made for the protection of consumers, investors, environment and national interest. For example, there are several organisations like SEBI, Consumer Commissions or National Green Tribunal (NGT) in India for the enforcement of such laws. Further, the legal environment of a country also includes taxation laws and annual budgets.

The changes in government policies such as trade policies, industrial policies, fiscal and monetary policies can have a great effect on the business. For example, by increasing the limits of permissible FDIs in the retail sector has led to the emergence of global e-commerce companies. While at the same time, it has been seen as the threat to local vendors with increasing markets for e-commerce.

3.9 ELEMENTS OF LEGAL ENVIRONMENT

Elements of the legal systems include the laws, rules and regulations applicable in the country. As per Rao (2008) it includes the following:

- Common law – Law is implemented according to the situation and the prevailing customs, traditions, culture, etc.
- Civil Law – They are the detail set of laws formulated, discussed and passed by the parliament e.g., contract act, company law and civil codes.
- Theoretical law – These are the laws derived out of the religious laws in the country.
- Property rights
- Intellectual property rights
- Labour laws and codes

- Fiscal and monetary policy
- Competition Law
- Foreign exchange laws – FEMA and FERA Act

We will discuss the above legal framework in the following section in detail.

Evaluation of Politico-Legal Environment

Political and legal environment plays an integral role in the economy. A favourable politico-legal environment is crucial for growth and survival of business. These factors govern the entry of foreign firms in the domestic market of the country. Government and allied agencies act as a regulator of foreign companies where government policies are considered to be gatekeepers. Political ideologies of the ruling party are also important for creating a favourable business environment. A pro-business ideology will lead to more opportunities for foreign investment in the country. Likewise, legal environment draws the perimeter of the permissible trade and commerce activities within the geographical boundaries of a country.

Business organisations are required to operate within the legal framework. Due to the rapid increase in globalization and flexible FDI policies, several laws are created to protect the interest of domestic traders in India. Business organisations are required to have full knowledge about the trade laws, rules and related policies. Moreover, the increasing complexity of legal environment can cause difficulties in the business operations. Increased concern about the environmental protection and sustainability has led to creation of environmental protection laws. Failure of implementing these laws will not only lead to governmental actions but will also effects the image of the business adversely. Hence, favourable politico-legal environment is necessary for a stable economic growth and development. Political instability can create social unrest which in turn can hamper local businesses in the area. For example, roadways, being blocked as protest-sites can hamper the supply chains.

Current Scenario of Politico-Legal Environment

Boost to Manufacturing

Government has given a boost to manufacturing activities in the country through 'Make in India' campaign. Under this campaign, government created conducive environment for doing business. In order to boost manufacturing in India, government has set up panels to fast-track investment proposals, addressing problems in investment process and creating an investor-friendly environment in the country. Efforts are being made to make India a manufacturing hub and crating more employment opportunities for the locals. In the recent times, several multinational companies have setup production facilities in India.

Changes in Industrial Policies

Several policy changes have been made in the recent past to ease the entry of foreign investments in the country. Department of Industrial Policy and Promotions (DIPP) has made efforts to make policies more flexible and simplified including infusing technology into various processes for effective and efficient governance. For instance, application for industrial licenses has been made online which has made it more accessible.

Business Reforms

Several reforms are being undertaken at state as well as centre level to make significant improvements in way business operates in India. The government has introduced various initiatives to ease doing business in India. India has been placed at 63rd position on World Bank's Doing Business 2020. For instance, Government of India has increased the limits of FDIs in insurance and defense sectors and thereby attracting more foreign capital in the country. This will lead to creation of employment and overall economic development ("Doing Business in India", 2020).

Bank Mergers

In the past few years, government has decided to merge certain public sector banks to reduce the number of nationalized banks and improve the quality of governance. The number of national banks has been reduced from 27 banks to 12 public sector banks (Singh, 2019).

Infrastructure Development

The current government has taken several steps for the modernization and development of infrastructure in the country. The focus is not only on the urban cities but several tier I and tier II cities have also been developed as the part of a scheme named as 'Smart Cities'. The government has announced to develop 100 cities as smart cities under which many industrial corridors are to build. Several other projects in different sectors like green energy, transportation and real estate have been planned. These planed projects will create future business opportunities and foreign collaborations (Yadav, 2015).

Skill Development Programmes

Indian government launched 'Skill India' movement in 2015 with an aim to provide skill based education to the youth of the country. The programme focussed at imparting vocational training with a vision to empower workforce suitable for skill-based jobs. For example, 'SeekhoaurKamao' was scheme launched for the youth of union territories of Jammu and Kashmir and Ladakh under which they were trained according to their qualifications and given employment opportunities in the state (NSDC, 2017). Such initiatives were planned to reduce the dependency white collar jobs and encourage skill-based employment.

Activity 3

How does the politico-legal environment impact the business decision making? Explain.

3.10 GOVERNMENT FRAMEWORK FOR PROMOTING BUSINESS

In the role of the government to support business and related economic activity, a robust supportive mechanism is required to be provided in promoting a sustainable institutional structure. Let us understand the selected government supported organisational set ups.

The Ministry of commerce and Industry

The Ministry of Commerce and Industry has the responsibility to manage and promote the industrial and commercial activity in the country. It formulates Industrial policy which provides with the planned framework of promoting industrial development in sync with the economic goals of the nation. The Niti Aayog, Ministry of Micro, Small and Medium Enterprises, Ministry of Skill development and Entrepreneurship all contribute in the attainment of their individual (promotional regulatory, technical and advisory) goals.

The Department for Promotion of Industry and Internal Trade (DPIIT)

The department was earlier called Department of Industrial Policy & Promotion and was renamed as DPIIT in January, 2019.The Department functions on matters related to Internal Trade, welfare of traders and their employees and start-ups. The role of DPIIT is to promote/accelerate industrial development of the country by facilitating investment in new and upcoming technology, foreign direct investment and support balanced development of industries.

The Department for Promotion of Industry and Internal Trade (DPIIT) spearheads 'the Ease of doing business' initiative which provides a 'carpet welcome' to the foreign investments to India. This involved providing time-based and 'single window clearances' towards establishing business in our country. The department also promotes Startup India Initiative and Production Linked Incentive (PLI) Scheme.

The Department of Commerce regulates the following:

I. International Trade: Policy related matters involving various tariff and non-tariff barriers, issues related to the WTO, their interpretation and implementation besides the dispute settlement/redressal mechanism. This further involves strengthening the bilateral and multilateral trade by International Commodity Agreements.

II. Foreign Trade (Goods & Services): tasks related to external trade and relevant matters import and export of feature films, as well as unexposed cine-films. This also involves establishing Agricultural Export Zone (AEZ) and 100% Export Oriented Units (EOUs) for boosting manufacturing and promoting external trade by suitably amending the related policy and regulatory framework from time to time.

Aimed at promoting international trade relations it attains the objective through bodies like Export Promotion Board, Board of Trade and International Trade Advisory Committee and Export Promotion Councils/Export Promotion Organisations. State Trading Corporation (STC) also facilitates the said objective of trade promotion.

III. Special Economic Zones (SEZs): Fostering economic development with SEZs is a relatively new way of attaining industrial as well as foreign trade growth. This includes providing a favourable policy environment, further comprising a conducive foreign trade policy, a supportive fiscal regime, and an attractive investment policy, etc. This is achieved by an organised structure and subordinate offices under this Department-

1. Directorate General of Anti-Dumping and Allied Duties (DGAD).
2. Directorate General of Foreign Trade (DGFT).
3. Directorate General of Supplies and Disposals (DGS&D).

IV. Statutory/Autonomous Bodies/Public Sector Undertakings/Other Organisations: Agricultural & Processed Food Products Export Development Authority (APEDA), Coffee Board, Export Inspection Council of India (EIC), Rubber Board, Spices Board, Tea Board, The Marine Products Export Development Authority (MPEDA), Tobacco Board. Public Sector Undertakings include: ECGC (Export Credit Guarantee Corporation of India Limited), ITPO (India Trade Promotion Organisation), MMTC Limited (formerly Minerals and Metals Trading Corporation of India Limited), PEC

Limited (formerly The Projects and Equipment Corporation of India Limited), STC Limited (State Trading Corporation of India Ltd.), STCL Limited (formerly Spices Trading Corporation Ltd.).

Of the many acts applicable under the Ministry of Commerce and Industry regime, 'Special Economic Zones Act, 2005', carries a mention here.

The Tariff Commission

Tariff Commission in India got created by the union of the Tariff Board, Tariff Commission (old) and Bureau of Industrial Costs & Prices (BICP). BICP got combined with it for better functioning with effect from 1st April, 1999.

Activity 4

You wish to start a manufacturing and distribution of edible oils and similar FMCG products. How you can get support from the above government bodies? Explain.

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NITI AAYOG (NATIONAL INSTITUTION FOR TRANSFORMING INDIA)

It was in 2014, that the NITI Aayog (National Institution for Transforming India) got constituted by transforming the earlier existing 'Planning Commission' for enhancing the developmental process; nurture an overall business enabling environment extending from the realms of Public Sector and Government of India. This involved more coordinated role with the state governments thereby strategically fostering good governance, best practices, providing strategic expertise and coordination with all levels of government (central as well as the state) for the collective attainment of developmental goals.

Public Private Participation (PPP)

The PPP Vertical is assigned with the various activities involving the policy formulation for ensuring that the desired objectives for timely creating the infrastructure to promulgate the economic growth and development. Such projects being capital intensive in nature requires regular capital infusion and management thus the PPP becomes the choice for Construction, Operations and Management of the infrastructure projects. For Niti Aayog, the PPP remains evolutionary, in terms that it remains reform-oriented by suggesting institutional, regulatory and procedural changes. By process and document standardization, the subsequent appraisal of PPP projects becomes easy thus resulting in higher FDI in such developmental projects.

The Ministry of Finance

It was re-organized in the year 1949 in two departments namely, the Department of Revenue and Expenditure; and Department of Economic Affairs. Presently, the Ministry of Finance has the following five Departments: -

a) Department of Economic Affairs
b) Department of Expenditure
c) Department of Revenue
d) Department of Financial Services
e) Department of Investment and Public Asset Management
f) Department of Public Enterprises

The Department of Economic Affairs, assists the Central Government in maintaining sound public finances through efficient use of the nation's economic resources, promoting conditions that accelerate sustainable economic growth through developing sound economic policies and preparing for future economic challenges and opportunities, and leading India's bilateral and multilateral economic and financial engagements. It manages the matters with its institutions like:

i. Security Printing and Minting Corporation of India Ltd.
ii. National Savings Institute.
iii. Securities and Exchange Board of India.
iv. Securities Appellate Tribunal.
v. Specified Undertaking of the Unit Trust of India/National Financial Holding Company Ltd.
vi. National Skill Development Corporation.

vii. National Skill Development Fund/Trust.
viii. National Skill Development Agency.
ix. Delhi Mumbai Industrial Corridor Trust.
x. Forward Markets Commission

FISCAL AND MONETARY POLICY

These two policies formulate the financial framework of the nation. Monetary and Credit Policy, is formulated by the Reserve Bank of India by which it aims at bringing in price stability, control inflation and regulate liquidity of the nation's economy. This is achieved through various instruments like managing the money supply and other policy matter changes from time to time. Through the banking system it regulates liquidity and interest rates and loan off takes for spurring industrial growth. With the Monetary Policy, the RBI strikes the balance between maintaining liquidity and credit/ loan off take by regulating between lending and borrowing rates of interest for the commercial banks. This is achieved through careful assessment of the business environment and then attaining the objectives with deployment of its instruments like Bank Rate of Interest, Cash Reserve Ratio, Statutory Liquidity Ratio, Open market Operations, Margin Requirements, Deficit Financing and printing of currency and credit regulation. It strives for establishing a price stability to overcome the fluctuations which may deter the market sentiments, especially in the foreign trade. This generates national economic growth and aids in employment generation too.

The fiscal policy is the nation's revenue and expenditure policy by which it plans to strike the balance between the ever growing needs and the limited resources availability in the country. It indicates the prioritization in the several governmental purchases and taxes. It is done by virtue of its 'thrifty nature' by promoting saving and investments in order to maximize the demand which stands important in not only providing economic stability but also aids in the time of recession. This is achieved through careful assessment, budget provisioning and limiting the Govt. expenditure, Tax management (Direct, indirect and new taxes), Wage Control, Public Debt and maintaining surplus budget etc.

On one side the Monetary policy acts by altering money supply and the interest rates; the fiscal policy aims for bringing in much needed price stability by carefully and continuously managing between the incomes and the expenditures of the country in order to provide a conducive and stable environment for providing economic growth, overcoming recession and generating opportunities for employment, infrastructure building, law and order, education, etc.

3.11 UNDERSTANDING THE LEGAL ENVIRONMENT

For describing and analyzing the legal environment of business in India, we present here briefly an overview of some specific socio-economic legislation. We may list these legislations which define the legal environment of business.

A. Company Laws

For smooth governance of the business, the company laws play a crucial role. These become the focal laws which impact the commercial environment and subsequent decision making. These important set of laws are governed by the Ministry of Corporate Affairs through the Companies Act, 1956, 2013 and other allied acts, bills and rules. The underlying object is to safeguard the interest of various investors, stakeholders and customers. Two primary bodies ensure its execution namely the Serious Fraud Investigation Office (SFIO) and the Competition Commission of India (CCI). Different acts which are constituted in this direction are "Companies Act 2013, Limited Liability Partnership Act, 2008, Insolvency and Bankruptcy Code, 2016, Competition Act, 2002, Partnership Act, 1932, Chartered Accountants Act, 1949, Cost and Works Accountants Act, 1959, Company Secretaries Act, 1980, and Societies Registration Act, 1860" etc. It is regulated through National Company Law Tribunal (Tribunal or NCLT), National Financial Reporting Authority (NFRA), and the Serious Fraud Investigation Office (SFIO).

COMPANIES ACT 2013

Meant at improved corporate governance and increased accountability, this act aims at improving the 'ease of doing business' in India. It brings forth conceptions like one–person company, small company, dormant company and corporate social responsibility (CSR) etc. It hosts noteworthy modifications in the ways of doing business, including the technologically advanced ways such as improved governance (e-governance), e-management, timely and orderly compliance, legal enforcement, self-disclosure and related norms, role of auditors, mergers and acquisitions, class action suits and registered valuers.

a) **The One Person Company:** requires having minimum paid up capital of INR 1 Lac without any legal obligation for holding Annual General meeting (AGM).
b) **Small Company (**other than a public company) with a paid-up share capital of maximum fifty lakh rupees or upto five crore rupees (if prescribed) or its last reported profits is not more than two crore rupees and turnover of maximum twenty crore rupees (if prescribed).
c) Minimum members for private company –maximum member heads can be 200 now from the earlier 50.

d) All official communications, should bear the full name of contact person, address of company's registered office, Corporate Identity Number (CIN No. which is a 21-digit number allotted by Government), Telephone number, fax number, Email id, contact website (if any).

e) All companies (public/private) under the Companies Act 2013 to comply with the Registrar of Companies (RoC) for beginning their business operations. They require submitting the Performa with the director's declaration mentioning the subscribers/ promoters, with the number of paid-up shares or agreed to be taken by them. The company also requires verifying its registered office with the RoC.

f) The new Companies Act 2013 mandates closing the financial year by the 31stMarch. Also the eligible age for Managing Director or whole time Director is decreased from 25 to 21 years.

g) The Indian company requires constituting a 'CSR committee' and 2% of the average net profits of the last three financial years be compulsorily be spent on the CSR activities subjected to fulfilment of certain conditions like the minimum net worth of INR 500 cr. Or minimum annual turnover of INR 1000 cr. or net profit of Rs. 5 crore or more.

h) Financial Statements are now defined under the act as comprising of all companies (except one person company, small company and dormant company) are now mandatorily required to maintain the following, which may not include the cash flow statement), a balance sheet as at the end of the financial year, a profit and loss account / an income and expenditure account for the financial year, as the case may be Cash flow statement for the financial year, a statement of changes in equity (if applicable) etc.

B. Capital Market

Let us understand the legal framework, structure and working of the Indian Capital markets.

The Securities Contracts (Regulation Act, 1956)

SCR Act 1956 is the core law which governs the activities of the Indian stock exchanges. Besides safeguarding the investors, it aims to curb unsolicited transactions/dealings of securities and formulate a transparent mechanism. This act recognizes various stock exchanges' memberships and the rules governing thereof; lays down processes for trading activities, including that of security contracts and listing of the securities at the bourses.

By definition, "A stock exchange has been defined as a body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling, or dealing in securities". Our country had a separate mechanism to operate the stock exchanges across the nation but now we have nine recognised stock exchanges namely, the Bombay Stock Exchange (BSE), Calcutta Stock Exchange (CSE),

India International Exchange (India INX), Indian Commodity Exchange Limited, Metropolitan Stock Exchange of India Ltd., Multi Commodity Exchange of India (MCX), National Commodity & Derivatives Exchange Ltd., National Stock Exchange Ltd. (NSE) and NSE IFSC Ltd.

Securities and Exchange Board of India Act, 1992

Enacted on 4thApril, 1992, the SEBI Act aims developing the securities market in transparent and disciplined manner for providing investor protection. It attains for providing fairness in dealings, high governance and institutionalization of standard business practices aimed at fostering efficiencies by an integrated system offering the services at genuine costs thereby building trust in investors and issuers, both; flexible to continuously match the emerging requirements.

SEBI is a statutory regulatory body established under this act. The SEBI board comprises of the chairman, two members of finance and law background nominated by the Central Government, one member from the RBI, and two more members appointed by the Government of India. They ensure the investors security in various ways. Cumulatively, the SEBI pursues the following functions:

a. Manage the stock exchanges' and security markets' business operations.
b. Registering and supervising various capital market entities like stock brokers, sub-brokers, share transfer agents, bankers to public issues, trustee of trust deeds, registrars to public issues, merchant bankers, underwriters, portfolio managers, investment advisers and similar intermediaries or self-regulatory organisations having roles in the capital markets. This also includes recording and managing the combined investment schemes like the mutual funds.
c. Curbing prohibitive, fraudulent, unfair and unethical trade practices by promoting investors' education, training and awareness initiatives of intermediaries and customers.
d. Prohibiting 'insider trading'. It also regulates the acquisition of shares, mergers and takeovers.
e. Periodic audits of the bourses and related intermediaries, seeking information, inspections, enquiry matters etc. The board may levy underlying fee or similar charge for it. Besides, the board carries research for the above purposes to coordinate and regulate the control over the activities performed.

Over-the-Counter Exchange of India (OTCEI)

OTCEI was established in 1990 (started functioning in 1992) as an electronic stock exchange without a proper trading floor. The Exchange was established with an objective of supporting enterprising promoters for securing cost effective project finance besides offering its investors with transparent transaction systems. It went further in the capital markets by providing technologically enabled mechanisms like screen-based nationwide trading, market making and scrip-less trading. The OTCEI performs the following functions:

i) Extend services to small companies for generating cost effective funds from the capital market;
ii) Provide easy access for the small investors to the capital market. Also, facilitating investors' by boosting their confidence;
iii) Smooth, transparent investor grievance redressal mechanism even to the far geographical areas; and providing much required liquidity.

Activity 5

Differentiate between a traditional stock exchange like BSE and OTCEI? Cite how OTCEI has its advantages?

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C. Foreign Exchange Management Act (FEMA)

Under the guidance from the central government which articulates the foreign trade policy, the central bank i.e. the Reserve bank of India carries the responsibility of implementing it by deploying the foreign exchange control act, known as "Foreign Exchange Regulation Act 1947". This act stood updated in the year 1974 by FERA. Thereafter in 1991, the globalization saw the requirement of newer policy measures and thus FERA made way for the Foreign Exchange Management Act (FEMA), 1999. It carries significance in the view point of foreign trade and

foreign exchange. It is applicable on any business entity involving an Indian resident. Significant features of FEMA are enlisted below:

I. Limitations concerning assets owned by the non-residents and transactions pertaining to bringing in and taking out of the currency and precious metals stood abolished. Limitation pertaining to the acquisitions of immovable property and its holding etc. in India also has been done away with.
II. Hospitality to non-residents on Indian visits stood allowed. On similar lines, the Indian residents visiting outside India for related activities stood allowed too.
III. Lowered restrictions for holding the immovable property outside India.
IV. Cases pertaining to seeking funds, deposits or loans in India from the Indian residents stand simplified. Also, foreign nationals need not seek approval for taking up employment in India; appointment of people as agents, advisors on technical/ management profiles relaxed. The new act encourages setting up of branch offices/ liaison offices encouraged and foreign travel permissions have been relaxed.

This act aims at consolidating and amending the legal forex related impediments to promote international business and external trade besides regulating the Indian forex market.

Activity 6

Study the recent cases of Reliance Infrastructure, Flipkart and Naresh Goyal of Jet airways on the topic and share your views on each.

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D. The Sick Industrial Companies (Special Provisions) Act 1985, (SICA, 1985)

The rapid industrialization clubbed with the multinational corporations influencing the business environments in India, there was a growing need for institutionalizing an act to govern the menace of growing industrial sickness. On one hand the government puts efforts to promote the industrial setups and on the contrary when these setups are graded 'sick' it causes multiple

damage in terms of employment, production loss, locking of funds etc. So reviving these companies to salvage and monetise the assets becomes important. Thus, the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) was legislated for appropriate recognition of sick (and potentially sick) companies. In the same direction the SICA proposed the constitution of the Board for Industrial and Financial Reconstruction (BIFR) for identifying the industrial sickness reason, its extent and putting forward remedial measures to limit the sickness. Besides it aims to contain this sickness and take measures to revive these industrial units. From 1st December' 2016, the SICA stood repealed by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 ("Repeal Act"), thereby diluting the BIFR and its constituent/ related bodies.

SICA and its Repeal

Broadly, the functioning of BIFR and AAIFR (Appellate Authority for Industrial and Financial Reconstruction) was not only much time consuming but stood uncertain too. It was therefore decided to solve the ambiguities and single entity be formed to handle and dispose all such company related matters.

Thus, the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT) were formed under the guidelines of the Companies Act, 2013 (Companies Act). The NCLT works on the company management issues and it got further strengthened by the Insolvency and Bankruptcy Code, 2016 (Bankruptcy Code) thus obsoleting the BIFR and AAIFR besides the pending proceedings only.

SICA has the following objectives:

i. identification and timely perusal of sick and potentially sick business entities;
ii. initiation of the 'Redressal mechanism' for fast resolvance, either preventive or remedial process by the expert panel;
iii. accelerate the desired corrective actions;
iv. apprehend, review and coordinate for future scope.

With the increasing complexities in the politico-legal business environments, SICA became obsolete in combating corporate sickness.

THE INSOLVENCY AND BANKRUPTCY BOARD OF INDIA

The board, established on 1st October, 2016 under the Insolvency and Bankruptcy Code, 2016 (Code), is one of the important pillars in the corporate business system which relates to the various laws pertaining to re-organisation/ restructuring, insolvency of the company and

resolution pertaining to corporate board and stakeholders, partnership firms on scheduled timelines. It aims at asset maximization (both in quality and quantity), encouraging entrepreneurship, leveraging assets, etc.

Being a one of its kind entity, it strives to aim at business governance by enhancing its processes. It oversees the Insolvency Professionals, Insolvency Professional Agencies, Insolvency Professional Entities and Information Utilities by regularly administers the processes pertaining to corporate insolvency resolution, corporate liquidation, individual insolvency resolution and individual bankruptcy. It has recently been tasked to promote and manage corporate insolvencies.

The function of the Chapter XIX (sections 253 to 269) in Companies Act, 2013, particularly pertains to the revitalization of the sick units. In the initiatives towards 'Ease of Doing Business' 27 Sections have been amended in the Companies (Amendment) Act, 2017including redefining the Associate Company by bringing in the Joint venture perspective. The voting powers of subsidiary company was also changed. Disclosures by the companies at the time of prospectus to SEBI were added to. Other modifications involved loans, audits and qualifications and powers of the directors.

Insolvency and Bankruptcy Code, 2016

The competitive business environments, particularly resulting from the evolving technologies and increasing competition have served to be an enabler for new businesses but on the other hand, the weaker ones increasingly demonstrated tendencies towards sickness thus seeking amendments in repealing the SICA Repeal Act. This was executed by substituting the section 4, sub-clause (b), the following sub-clause shall be substituted, namely—

"(b) *On such date as may be notified by the Central Government in this behalf, any appeal preferred to the Appellate Authority or any reference made or inquiry pending to or before the Board or any proceeding of whatever nature pending before the Appellate Authority or the Board under the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) shall stand abated:*

Provided that a company in respect of which such appeal or reference or inquiry stands abated under this clause may make reference to the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016 within one hundred and eighty days from the commencement of the Insolvency and Bankruptcy Code, 2016 in accordance with the provisions of the Insolvency and Bankruptcy Code, 2016:

Provided further that no fees shall be payable for making such reference under Insolvency and Bankruptcy Code, 2016 by a company whose appeal or reference or inquiry stands abated under this clause.

The provisions of the Code dealing with amendment to the SICA Repeal Act came into force from November 1, 2016; however, the Ministry has appointed December 1, 2016 as a date on which the provisions of the SICA Repeal Act shall come into force. A question may arise as to which date shall be considered i.e. November 1, 2016 or December 1, 2016. On careful reading, one may note that clause (b) of section 4 states as follows:

The Central Government, vide notification dated November 25, 2016 has notified the provisions of the SICA Repeal Act. Therefore, any reference made to BIFR, any inquiry pending before BIFR, any appeal preferred to AAIFR, or any proceedings pending before BIFR/AAIFR shall automatically stand abated w.e.f. December 1, 2016."

Defining a 'Sick Company'

The sick company thus is defined as "Where on a demand by the secured creditors of a company representing fifty per cent or more of its outstanding amount of debt, the company has failed to pay the debt within a period of thirty days of the service of the notice of demand or to secure or compound it to the reasonable satisfaction of the creditors, any secured creditor may file an application to the Tribunal in the prescribed manner enclosing relevant evidence for such default, non-repayment or failure to offer security or compound it, for a determination that the company be declared as a sick company".

E. Monopolies and Restrictive Trade Practices (MRTP) Act 1969 (MRTP ACT)

The MRTP act has its roots arising out of the Directive Principles of State Policy embodied in the Constitution of India. Article 39(b) and (c) which says to ensure:

i) "that the ownership and control and material resources of the community are so distributed as best to sub serve the common good, and
ii) that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment".

Monopolies generally benefit a few but harm many as they tend restricting the competition mainly controlling the prices of commodities in the market thereby resulting manipulation by a few.

The MRTP (Amendment) Act, 1991, has omitted provisions regarding the Central Government's permission for substantial expansion, establishment of a new undertakings, mergers, take-over,

etc. Establishments, howsoever big or small, are now free to expand, or establish new undertakings, or effect mergers.

Monopolistic Trade Practices

"Any trade practice which leads or is likely to lead to any of the following effects is regarded as a monopolistic trade practice:

i) Unreasonably high price;
ii) Unreasonably high cost of the production of goods or the provision of services;
iii) Unreasonably high profits;
iv) Prevention or reduction of competition;
v) Limited technical development;
vi) Limited capital investment; and
vii) Deterioration in the quality of goods"

Restrictive Trade Practices

The term restrictive trade practice is defined t mean a trade practice which has or may have the effect of preventing, distorting or restricting competition in any manner and in particular if it:

i. tends to obstruct the follow of capital or resources into the stream of production; or
ii. tends to bring about manipulation of prices or conditions of delivery or to affect the flow of supplies in the market relating to goods or services in such manner as to impose on the consumers unjustified costs or restrictions.

Every agreement falling within the one or more of the following categories is deemed to be an agreement relating to restrictive trade practices and is subject to registration under the Act:

- Refusal to deal and/ or Boycott
- Tie-up sales and Exclusive dealing and/or Discriminatory dealings or Territorial restriction/restrictions or withholding of output or supply
- Concert in prices and terms and conditions of purchase or sale
- Resale price maintenance and controlling manufacturing process
- Agreement having the effect of eliminating competition/competitors etc.

Unfair Trade Practices

They have been defined as per the Act "to mean a trade practice which for the purpose of promoting sales, use or supply of any goods or for the provision of any services, adopts any

unfair method or deceptive practice, including: i) bargain sale, ii) bait and switch selling, iii) offering gift or prizes in promotional contests, and not providing them etc".

F. Consumer Protection Act, 1986

Our country has been a large market and has attracted traders from the business and commercial perspective. Owing to the large geographical spread and low level of education amongst the people, the fraudulent practices were witnessed and in order to curb them many legislations were enforced like the Sale of Goods Act, 1930; Essential Commodities Act, 1955; the Prevention of Food Adulteration Act, 1954; Prevention of Black Marketing and Maintenance of Supplies of Essential Commodities Act, 1980; Standards of Weights and Measures Act, 1956; Agricultural Products Grading and Marketing Act (AGMARK),1937; Indian Standards Institution Certification Act, 1952; MRTP Act, 1969, etc.

MRTP Act though was able to put a check on the rapidly increasing consumer fraudulent practices the need for an inclusive consumer protection legislation was much required, thus making way for the Consumer Protection Act, 1986 for providing fast and cheap redressal to consumer grievances.

The Act recognizes the following six rights of consumers namely:

1. "Right to safety, i.e., the right to be protected against the marketing of goods and services which are hazardous to life and property.
2. Right to be informed, i.e., to be informed about the quality, quantity, potency, purity, standard and price of goods or services, as the case may be, so as to protect the consumer against unfair trade practices.
2 Right to choose, i.e., the right of access to a verity of goods and services at competitive prices. In case of monopolies, say railways, telephones, etc., It means right to be assured of satisfactory quality and service at a fair price.
3 Right to be heart, i.e., the consumers; interests will receive due consideration at appropriate forums. It also includes the right to be represented in various forums formed to consider consumers' welfare.
4 Right to seek redressal, i.e., the right to seek redressal giant unfair practices or restrictive trade practices or unscrupulous exploitation of consumers.
5 Right to consume education, i.e., the right to acquire the knowledge and skill to be an informed consumer."

G. Competition Commission of India

The informal activity of regulating the market rivalry by business houses is traditional however it surfaced in the year 2002 when the government recognised the need to regulate this market competition and thus the Monopolies and Restrictive Trade Practices Act of 1969 was repealed thereby making way for the Competition Act of 2002. This act was subsequently amended in 2007 and 2009. The act proposes for a legitimate framework be articulated and practiced in the competition policies (thereby curbing the anti-competitive practices with punitive action). CCI was formed under this Act which makes way for providing an environmental culture imbibed with free, fair and healthy market competition, clubbed with trade freedom and customer and societal orientation. This forms the three structural pillars to deter the unhealthy competition namely, anti-competitive agreements, their combination meanings and abuse of dominance. The commission stands empowered to levy penalty on the offenders amounting "up to 10 per cent of the average turnover of the company" during the last three financial years upon all offending enterprises and/or alleged individuals. Further, the entities found involved in cartelization by the Commission can be penalized for the higher amount of 'up to three times of the profit' for the found period, or ten per cent of the turnover for the period in the agreement.

H. The Environment Protection Act, 1986

The Indian Constitution mentions Indian citizens compassionately protecting and improving the natural environment including forests, lakes, rivers and wild life. In this direction, the Environment Protection Act, 1986, envisaged with two complementing acts namely the Water (Prevention and Control of Pollution) Act,1974, and Air (Prevention and Control of Pollution) Act, 1981, have an objective to lay down a framework for environmental protection and its subsequent preservation. The components of the natural environment comprise of water, air and land besides their interactive relationships with humans and other living elements and the ecosystem. This act enables the Central Government with certain powers to protect and improve the environmental quality by curbing and abating the environmental pollution. This involves constituting and delegate authoritative office to achieve the abovementioned objectives.

I. A Few Other Legislations

We have understood by now that the legally structured environment stands robust enough and we have gone through certain laws and enactments influencing the said environment. Besides them, there are certain more legislations which impact the Indian business environment in various other conditional circumstances:

1. The Essential Commodities (Amendment) Act, 2020. Encapsulates tough penal action for the alleged entities or people. The act proposes stringent legal framework for antisocial elements like hoarders, profiteers, smugglers and black-marketers.
2. The Trade Marks Act, 1999.
3. The Patents (Amendment) Act, 2005.
4. The Urban Land (Ceiling and Regulation) Act, 1976.

Activity 7

1. Study the case of NCLT- Tata Sons Vs Cyrus Mistry. Share your views.

2. Posco, a steel business conglomerate, had plans to enter India in 2005 and had a MoU to establish a steel plant in Odisha. The investments were in tune of USD 5 Billion but it faced several issues in this regard. Mention the point wise details of what went wrong with Posco deciding to abandon the business there in 2017.

3.12 SUMMARY

Socio-cultural environment consists of social and cultural elements affecting the growth and development of an economy. They include knowledge, beliefs, values, morals, behavior, attitudes, religion, ethnicity and language. Politico-legal environment is a combination of political environment and legal environment. It consists of laws, governments, statutory bodies, judiciary, executive council and legislature. Politico-legal environment changes with each political development in the country. Sometimes, legal reforms are based on the changes in the ideologies of the ruling government. These elements can lead to either threat or opportunities for a business organisation. Any organisation desiring to operate in a country need to undertake socio-cultural as well as politico-legal elements into consideration before planning a strategy.

The Ministry of Commerce and Industry promulgates the policy support to the businesses besides playing a pivotal role in 'ease of doing business' initiatives. Other legal and policy support extended by law enactments like the Competition Commission of India, SICA, Consumer Protection Act, Environment Protection Act bolsters the business functions in other perspectives arising from time to time.

3.13 KEY WORDS

Expansion: The govt. can both provide business house, the opportunity to expand as well as restrict their expansion activities. Earlier, through the MRTP Act the government restricted the expansion of big houses, besides which various restrictions were imposed on increasing production capacity or launching new variants.

Foreign Direct Investment: It is the government that decides whether MNCs can invest in a country or not. Because of these government policies there are very few MNCs in India.

Incentives: The government also regulates the industry by providing incentives in the key thrust areas. For instance, it gives tax breaks if an industrial unit is established in a backward area. It also grants subsidies under various schemes to the small scale sector.

Legal Role: The Parliament is the law making authority and it is the council of ministers that presents the proposed law on the table of parliament.

A Special Economic Zone (SEZ) is a demarcated area which carries out activities to promote export by granting subsidies and tax relaxations on exports, import licenses and less import duty for exporters, and easy financing through banks.

3.14 SELF-ASSESSMENT QUESTIONS

1. What are the important elements of socio-cultural environment? Explain.
2. How politico-legal environment does impact various businesses? Discuss.
3. Discuss how the government regulates business.
4. Share your views on the MRTP Act? Enlist the various amendments being made in the said act.
5. Explain the objective for the formation of SEBI by the government of India.
6. Share your views on the statement "The best protection to consumer is the full and fair play of market forces".

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UNIT 5 INDIAN FINANCIAL SYSTEM

Objectives

After reading this unit, you should be able to :

- explain the importance of the financial system;
- describe the structure and working of the money market and capital market;
- outline the structure of the banking system; and
- examine the working of the capital market along with its various instruments and intermediaries.

Structure

5.1 Introduction
5.2 Financial System and Working of Financial Markets
5.3 Structure of Money Market
5.4 Banking Structure in India
5.5 Reserve Bank of India
5.6 Scheduled Banks in India
5.7 Structure of Capital Market
5.8 Summary
5.9 Key Words
5.10 Self -Assessment Questions
5.11 References/ Further Readings

5.1 INTRODUCTION

Before dwelling into the various intricacies of the financial system you need to understand capital accumulation and its importance. In the previous units, you have read about different theories of economic growth and have realised that for an economy to achieve higher levels of both economic growth and indeed economic development, the role of capital formation is indispensable. Capital formation means an addition/increment in the existing stock of real capital available in the country. Capital in economics terminology does not mean money alone. It is a wider term that encompasses both physical and human capital. Physical capital like machines, tools, infrastructure, raw material, etc. leads to more production, profits and

the creation of assets in future. Human capital on the other hand includes skills, training, education, etc which improves the productivity of individuals and especially labour.

Saving and investment are two core components of capital formation. Saving in the simplest sense means the part of income that is not consumed. When saving is used in such a manner that it gives returns in future it becomes an investment. For example, you saved a certain proportion of your income and bought a piece of land. So buying land is an investment because if you sell it then the sale price of land will be higher than your purchase price and the margin between the two will be the profit. Now, instead of selling that land, you constructed a building on that land and then you gave it on rent. So, this rent will be an extra income for you and it will add to your current level of income or profit. So when savings are properly channelised it increases the stock of income or capital. As saving is important for an individual it is of paramount importance for an economy. A higher level of savings leads to more investment and capital formation which in turn becomes the source of economic growth. So, it is the creation of savings, mobilisation of savings and conversion of savings into capital assets that leads to capital formation.

There are large numbers of factors that affect the rate of capital formation in the country like income levels of the people, institutional factors like availability, number and coverage of financial institutions, the monetary and fiscal policy of the country, prevailing rate of interest, population, size of the market, etc.

5.2 FINANCIAL SYSTEM AND WORKING OF FINANCIAL MARKETS

A financial system consists of a set of institutions, instruments and markets which brings the savers and the investors to a common platform and provide the means by which savings are translated to investment. The principal objective of the financial system or financial markets is to channelise the savings into the most productive opportunity/avenues. In financial markets, there are two players namely lenders and borrowers. Individuals/ Households generate savings and have surplus funds. They can either put this amount of money in gunny bags and hide it or keep it under lock and key as was done in yester years. This form of savings did not yield any return and the constant fear of theft always lured upon the savers. On the other hand, capitalists/ entrepreneurs could not undertake new projects of production or expand the existing production capacity of the plant due to a dearth of capital. The major role of the financial system of the financial market is to bring these two together. Those who have savings (savers or lenders) put funds into banks and other financial institutions and

those in need of money or finance (borrower) take the money from these financial institutions. In this interaction both the lenders and borrowers gain and ultimately due to increased efficiency, production and exchange the whole economy gets benefitted.

The working of financial markets can be understood from the flow chart (Figure 5.1). The households save money in the financial system and these funds are channelised and in the form of loans are provided to the borrowers.

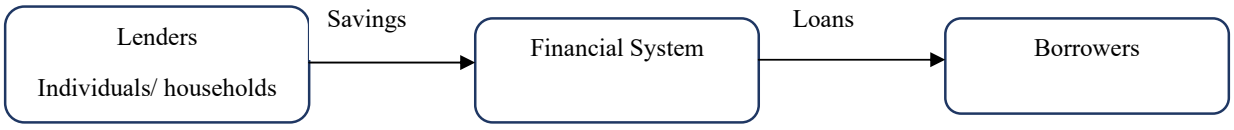

Figure 5.1 : Working of Financial Markets

Financial markets perform many functions like:

- To connect borrowers and lender of funds and to lead to the process of price discovery/determination.
- To provide liquidity in the system by allocation of funds in an efficient manner.
- Easy access of funds to the borrowers which in turn reduces the cost of the transaction.
- Provides a way for managing uncertainty and controlling risks.

5.3 STRUCTURE OF MONEY MARKET

Financial markets have two main components money market and capital market and they both are essential for the economic development of the country. In the following section, you will read about the money market, its importance and various instruments. The money market is a market for short-term financial assets and assets which are close substitutes of money. Short term implies time period of less than one year and close substitutes of money refer to those financial assets that can be converted to money with minimum/no transaction cost and without loss in value. The major participants in the money market are scheduled commercial banks (excluding regional rural banks or RRBs), cooperative banks (excluding land development banks) and primary dealers (PDs).

Objectives

The broad objectives or functions of the money market are :

- To provide equilibrating mechanism between short term surpluses and deficiencies.
- Maintaining liquidity in the system.
- Providing access to short term funds to the borrowers at minimum or realistic cost.
- To enable the central bank of the country intervention to influence and regulate liquidity in the economy.

Instruments of the Money Market

The main instruments traded in the money market and the sub-market are:

- Call Market/ Notice Market
- Commercial Papers (CPs) Market
- Treasury Bills (T-Bills) Market
- Commercial Bills Market
- Certificate of Deposits (CDs) Market
- Money Market Mutual Funds (MMMFs)

Let us now discuss them in brief.

- **Call Market/ Notice Market**

  It is a market for short term financial fundsthatare payable immediately and in full when the lender demands them. It is for this reason that call money is also known as "money at call". The maturity period variesfrom one day to a fortnight (14 days). When the funds are browed/lent for a day it is called call (overnight) money. If the duration of funds borrowed/lent is more than a day and upto 14 days it is called notice market. For conducting transactionsin the call/notice market there is no need for any collateral security.The major players in the call market are banks and primary dealers.The interest rate payable on call loans is known as the call rate.

... **Commercial Papers(CPs) Market**

CPs are short term unsecured instruments issued by companies to raise short term debts. They are issued in the form of promissory notes and in India they were introduced in 1990. Large corporations, primary dealers and Financial Institutions (FI) are authorised to issue CPs. The maturity duration of CPs is a minimum of 7 days and a maximum of up to one year from the date of issue. They are typically issued to short term financial obligations like funding of the new project. They can be issued in denomination of Rs 5 lakh or multiples thereof.Further, all eligible participants need to obtain a credit rating for the issuance of CPs. They need to have a minimum credit rating of A2 as per the Securities and Exchange Board of India (SEBI) definition and rating symbol. CPs are issued discount to face value basis (as discussed in the T-bills example). They have many advantages like the option of diversification for the source of finance, higher returns and liquidity.

... **Treasury Bills or T- Bills**

T-bills are short term borrowing instruments by the government of India. These are a form of a bill that does not arise from any genuine transaction in goods. They are a kind of promissory note issued by the Reserve Bank of India (RBI). The government uses T-bills to raise short term funds to bridge the temporary/seasonal gaps when a deficit arises due to shortfall (situation when receipts fall short of expenditure). At present T-bills of 91 days, 182 days and 364 daysare issued. These bills are bought and sold on a discount basis means they are zero-coupon securities and yield no interest. For example, a 91 days T-bill of Rs 200 (which is the face value) may be issued at say Rs 198.20. So the discount on this T-bill is Rs. 1.80 and at the time of redemption it will be redeemed at the face value (i.e. Rs. 200). The return which investors gain is the difference between the face value (maturity value) and the issue price. T-bills are issued by RBI through auctioning.RBI conducts auctions of T-bills with a maturity period of 91 days, 182 days and 364 days every Wednesday. The date and place of auction, maturity time period and the method of auction is announced by the RBI from time to time.There are two main types of auctions namely multiple-price auction and uniform-price auction.The main features of T-bills are they are negotiable instruments, highly liquid because of the short time period, secured as they are backed

by the government guarantee, assured yield and low transaction cost. The net short term market borrowing of the government through 91 days, 182 days and 364 days T bills stood at Rs.37,528 crore during 2019-20.

- **Commercial Bills Market**

Commerical bills include bills of exchange and promissory notes. A promissory note is a form of financial instrument in which the note's issuer and the note's payee undertake a written promise whereby the issuer promise to pay a definite sum of money either on demand or at a specified future date to a particular person or to the bearer of the instrument. Commerical bills originate due to original trade transactions. There are many types of bills like trade bills, commercial bills, inland bills, foreign bills, indigenous bills and others. Rediscounting of bills is an important segment of the bill market. Commercial banks often make use of such facilities.

Let us understand the concept of rediscounting with a help of an example. Suppose a commercial bank buys 91 -days T-Bill at Rs 1000 and receives Rs 1100 at the time of maturity. In this case, the difference between the purchase price and face value of the bill is Rs 100 is called the discount. Re-discounting occurs when the short-term negotiable debt instrument is discounted for a second time. In continuation with the above example, let's assume that the same bank needs money urgently for say 30 days, it will approach the central bank of the country and the central bank can purchase some of the bills from the bank say for Rs 1050 for a period of next 30 days but before 90 days the date of maturity. In this case, the rediscount or the difference between the purchase price and the face value is Rs. 50.

- **Certificate of Deposits (CDs) Market**

CDs are negotiable money market instrument against funds deposited in a bank or other financial institutions for a fixed time period at a specific rate of interest. They are the bearer documents and issued in dematerialised form. Scheduled commercial banks (except RRBs and local area bank) and selected all India FIs can issue CDs in a minimum amount of Rs. 1 Lakh and in the multiples of Rs. 1 Lakh. The maturity period of CDs is a minimum of 7 days and a maximum up to one year. They are issued at a discount on face value. Banks have to maintain appropriate reserve

requirements i.e., Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) on the issue price of CDs.

... **Money Market Mutual Funds (MMMFs)**

To increase the participation of individuals and small investors in the money market and to provide additional short term funds avenues to the investors MMMFs were introduced in April1991 and the detailed scheme of MMMFs was announced by RBI in 1992. A mutual fund is an investment scheme mostly run by an asset management company. Money is collected from a large number of investors and this pool of money is invested in stocks, bonds and other securities. MFs are mostly beneficial for small investors like the salaried class who park their funds in MMMFs and can gain better returns. They offer diversification of short terms assets in terms of issues, maturity and volume, thereby spreading the risk. Whenever investor buys mutual funds they are allotted units/share of the mutual fund. These MFs are professionally managed and investors earn income in the proportion to the number of units owned by them. Initially, only banks, FIs and their subsidiaries were allowed to set up MMMFs but corporates and others were allowed for the same from 1996. All MMMFs are governed and regulated by SEBI.

Structure of Money Market in India

The structure of the money market in India is presented in Figure 5.2. The money market is divided into two parts i) Organised and ii) Unorganised.

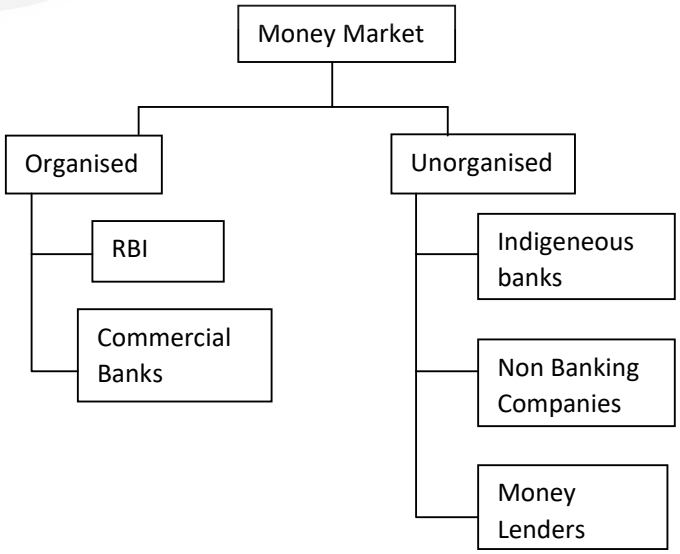

Figure 5.2 : Structure of Money Market in India

The organised sector consists of the central bank of India or RBI, commercial banks both nationalised and private. Further, foreign banks, cooperative banks, the discount and finance house of India and other financial institutions like IFCI, ICICI, LIC, GCI and mutual funds also operate in the money market. The unorganised sector consists of non-bank financial intermediaries, indigenous bankers and money lenders.

5.4 BANKING STRUCTURE IN INDIA

As discussed previously banks are one of the most important segments of the money market. Let us read about the banks, their functions, the structure of the banking system in India with special reference to RBI.

Definition of Bank

According to the Banking Regulation Act 1949, a banking company is a company that transacts the business of banking in India and banking means accepting deposit of money from the public for the purpose of lending or investment however with the promise of repayment on the demand by the depositor with the facility of withdrawal by cheque, draft, order or otherwise.

The functions of banks have changed from traditional (accepting deposit and lending credit) to many more functions like collection and payment of cheques, bills and promissory notes, sale and purchase of securities, remittances of funds, merchant banking, services of automated teller machines (ATM), electronic fund transfer system, dealing in foreign exchange, and others.

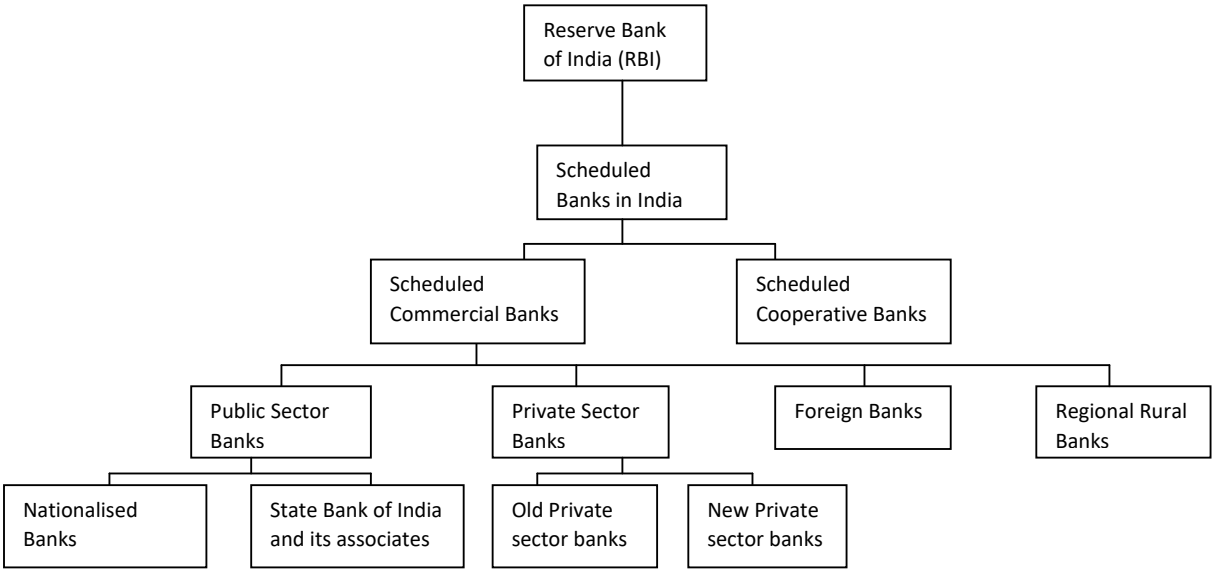

Figure 5.3: Banking Structure in India

The structure of banking in India is presented in Figure 5.3. At the helm of the affairs, there is RBI which is the regulator of the banking sector and supervises the monetary policy of the country. After that, we have scheduled banks that are further classified as scheduled commercial banks and scheduled cooperative banks. Public sector banks, private sector banks, foreign banks and Regional Rural Banks(RRBs). Within the Public sector, there are nationalised banks and the State Bank of India (SBI) and its associates. Private sectors banks have two categories old and new private sector banks. In the following sections, you will briefly read about them.

5.5 RESERVE BANK OF INDIA (RBI)

RBI is an apex bank of the country and acts as the regulator of the financial and monetary system in the country. It was established after the recommendation of the 'Hilton- Young Commission'. It was established as a banker to the central government by the Reserve Bank of India Act 1934 and it began its operations from April 1935 as a private shareholders bank with the paid-up capital of Rs.5 crore and in 1949, RBI was nationalised.

Functions of the RBI

Some of the major functions of RBI are:

- Note Issuing authority
- Banker to the Banks

- Banker of the Government and Debt Manager
- Banking Sector Regulator
- Foreign Exchange Manager
- Maintaining Financial Stability
- Development Role
- Regulator of the Monetary Policy

Note Issuing Authority

RBI has a monopoly over note-issuing in India other than one rupee notes/coins and coins of smaller denomination. RBI ensures that both currency notes and coins are available in an adequate amount in the country. The currency notes issued by RBI are legal tender in the length and breadth of the country. RBI can issue currency notes up to the denomination of Rs. 10,000. At present notes in the denomination of Rs 2, Rs 5. Rs 10, Rs 20, Rs 50, Rs 100, Rs 200, Rs 500 and Rs 2000 are issued. Similarly, coins in circulation comprise Rs 1, Rs 2, Rs5 and Rs 10.

Banker to the Banks

All the banks in the country havean account in the RBI via which banks settle inter-bank transaction and customer transactions. It also enables banks in maintaining statutory reserve requirements like SLR and act as lenders of the last resort. It also provides short term loans and advances to banks as and when the need arises.

Banker of the Government and Debt Manager

RBI acts a banker to the central government of the country along with those state governments which have agreed with RBI. It maintains the government accounts and does financial transaction from this account along with the transfer of government funds. It manages the government domestic debt and raises the money both from the public and financial market to bridge the shortcoming of revenue.

Banking Sector Regulator

RBI regulates and supervises the banking system of the country in accordance with the various provisions of the RBI Act and Banking Regulation Act. RBI as a regulator does a wide range of activities like providing licenses, prescribing capital requirement like capital adequacy norms, paid-up capital and lending to the priority sectors of the economy like farmers, women, etc. Regulation of interest rate, an inspection of the banks and bank branches, setting of different regulatory norms and also to initiate new regulation in accordance to changing circumstances.

Foreign Exchange Manager

As you may have read that trade is very essential for any economy. For conducting trade adequate stock of foreign exchange reserves are an important requirement. RBI plays an important role in both the development and regulation of the foreign exchange market. It regulates the transactions which are related to both exports and imports and ensure smooth conduct in the domestic foreign exchange market. It is the custodian of foreign exchange reserves and the golds reserves of the country. The banks and selective institutions which wish to deal in the foreign exchange need to have a license from RBI.

Development Role

RBI aims at promoting financial literacy and education among the public and also ensures that credit is available to the productive sectors of the economy. For the development purpose RBI has established many institutions like the National Bank for Reconstruction and Rural Development (NABARD), Unit Trust of India (UTI), Deposit Insurance and Credit Guarantee Corporation, Industrial Development Bank of India (IDBI) among others.

Regulator of Monetary Policy

Monetary policy is the policy of RBI through which it regulates the financial market of the country and most importantly it is used for credit control. Credit creation is one of the chief functions of the bank. Before we move forward let us understand what is credit creation. Whenever the bank accepts a deposit from the customer, it retains some proportion(which is

mandatory) of this deposit for the requirement of the depositor and the rest is given as a loan to the buyer. So bank creates money out of money this process is called credit creation. It is through credit creation that money flows into the system. However, both the excess and deficiency of money circulation is damaging for the economy. If the supply of money is more than the demand then we have the problem of inflation which you have read in previous units. In contrast, if the money supply is less than demand then we have the problem of deflation. So, RBI uses monetary policy to control credit. Methods adopted by RBI for credit control are classified as i) Quantitative and ii) Qualitative.Lets us discuss these methods in detail in the following sections and once we have discussed these methods we can understand with the help of illustration how these methods are adopted for credit control.

Quantitative Methods

Quantitative methods are used to control total quantity or volume and the cost of the credit created by banks. Within Quantitative methods, we have direct and indirect instruments. Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR) and Refinance facilities are direct tools. Bank rate, Repo and Reverse repo rate, Liquidity Adjustment Facility (LAF), Open Market Operations, Market Stabilisation Scheme (MSS) and Marginal Standing Facility (MSF) are indirect instruments.

Cash Reserve Ratio (CRR)

It is the minimum amount that banks keep with RBI as a proportion of their Net Demand and Time Liabilities (NDTL). The CRR percentage is notified from time to time by RBI. CRR ensures that banks have sufficient cash for their depositor's requirement.

Statutory Liquidity Ratio (SLR)

It is the percentage of NDTL that banks have to mandatory maintain in safe and liquid assets like cash, gold or government securities. SLR restricts the expansion of bank credit, increases bank’s participation in the security markets especially government securities, and it also ensures the solvency of banks.

Refinance Facility

This facility is used by RBI to provide adequate credit to selective sectors like the export sector.

Bank Rate Policy

According to RBI Act, 1934, a bank rate is "the standard rate at which RBI is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this act". The bank rate has been aligned to the Marginal Standing Facility (MSF) and it changes automatically when MSF changes.

Repo Rate

It is the rate at which RBI lend to the banks overnight against the collateral of government and other approved securities under the arrangement of Liquidity Adjustment Facility (LAF). In simple terms, it is the fixed interest rate at which banks borrow from RBI for the short term. At present, Monetary Policy Committee (MPC) decides this policy rate along with the reverse repo rate.

Reverse Repo Rate

It is a fixed interest rate at which RBI borrows from the banks in order to absorb liquidity for the short term (overnight basis). RBI borrows against the collateral of eligible government securities under the LAF.

Liquidity Adjustment Facility: This facility was introduced by RBI after it was suggested by the Narasimham Committee on Banking Sector Reform of 1998. It is a mechanism for managing the liquidity needs of the bank. It aims to inject/absorb liquidity from the system in the situation of shortages and excess. The repo, reverse repo, term repo (auction), overnight variable rate repo (auction), overnight variable rate reverse repo (auction) are the components of LAF.

Policy Rates as on Arpil, 2021	
Cash Reserve Ratio (CRR): 3.50 %	Repo Rate: 4.00 %
Reverse Repo Rate: 3.35 %	Marginal Standing Facility Rate: 4.25 %
Bank Rate: 4.25 %	Statutory Liquidity Ratio: 18%

***Source*: Reserve Bank of India**

Open Market Operations

It refers to buying and selling of government securities by RBI in the money market. Both the purchase and sale of these securities may lead to expansion and contraction of the money supply. For example, at the time of inflation, RBI sells these securities and banks buy them. When banks buy these securities then bank credit is directed away from the public to RBI which leads to less credit creation and less supply of money in the market.

Market Stabilisation Scheme

In 2004 this scheme of RBI was launched in order to withdraw excess liquidity from the market by selling government bonds. The problem of excess liquidity was due to RBI purchase of foreign currency. The bonds which the RBI sells are called Market Stabilisation Bonds (MSBs) and they are owned by Government of India.

Marginal Standing Facility

It is a facility for banks that can be used in an emergency. Under this facility scheduled commercial banks can borrow up to one percent of their NDTL at 100 basis points (1 percent) more than the repo rate for the short term (overnight) from RBI. It provides a safety value to banks against unanticipated liquidity shocks.

INFLATION/ DEFLATION AND QUANTITATIVE METHODS

Lets us take an illustration to demonstrate how RBI uses these methods in the time of Inflation/deflation.Lets us assume that CRR is 10 percent and NDTL are to the tune of Rs.100. Now CRR is the proportion of NDTL which banks have to keep with RBI. So out of this Rs.100 banks have to keep Rs 10 with RBI so they can now create credit worth Rs.90. Now suppose that economy is witnessing inflation in which supply of money is greater than demand for money. At the time of inflation, RBI can increase CRR (Repo, Reverse repo and bank rate) to 15 percent, so now instead of Rs 10 banks have to keep Rs 15 with RBI and they can create credit worth Rs 85 only. So by increasing CRR (or other policy rates) RBI can curb the credit creation capacity of banks and reduce supply of money. On the other hand at time of deflation RBI reduces reserves so that more liquidity can be pumped into economy.

Qualitative Methods/ Selective Methods

These methods focus on certain sectors only. By using these methods RBI can divert the flow of credit from one sector to another. The different qualitative methods used by RBI are credit rationing, consumer credit regulation, increasing margin requirement, moral suasion, direct action and others. We will only discuss some of them in this section.

Credit Rationing

Under this method, RBI controls and regulate the purpose for which credit is granted by banks. The central bank can put a ceiling on the amount of loans that can be advanced to the banks.

Consumer Credit Regulation

This method helps in controlling excess spending by the consumers. RBI can direct banks to fix a minimum percentage of down payment, instalment amount, loan duration, etc.

Margin Requirement

Margin requirement is the difference between the market value of the security which is pledged for taking a loan and the maximum amount of loan which can be disbursed against this security. For example, the margin requirement is 10 percent and you wish to take a loan. You approach a bank for a loan with security which is worth Rs 1000. As the prescribed margin is 10 percent the bank keeps this margin and will lend you only Rs 900. Now if there

is an excessive money supply in the economy then RBI can increase this margin to say 30 percent. So instead of Rs 900, you will get a loan of Rs 700 against the same security. So in the situation of inflation, this margin is increased and during deflation, it is reduced.

Moral Suasion

RBI requests or persuades commercial banks to behave in a particular manner according to the financial situation of the economy. For example, during inflation RBI requests commercial banks to restrict bank advances.It is a sort of advice and there is no compulsion by RBI. The effectiveness of this policy depends upon coordination between RBI and commercial banks.

Direct Action

It refers to the direction and the controls which RBI enforces on particular or all banks in case of default or no adherence to advise of RBI. RBI can reject the request of banks for grants or rediscounting facilities or it may levy penal rate interest on loans that banks borrow beyond the prescribed limit.

5.6 SCHEDULED BANKS IN INDIA

Scheduled banks are those banks that are included in the second schedule of the RBI Act, 1934. These banks need to have paid-up capital and reserves of not less than Rs 5 lakhs. These also need to maintain CRR balance with RBI and they can raise debts and loans from RBI at the bank rate. Scheduled commercial banks are further classified as public sectors banks, State Bank of India (SBI) and its associates, old and new private sector banks and foreign banks.

Public Sector Banks(PSBs)

PSBs are those banks in which more than 50 percent of shares are held by the GoI. These are the major type of banks in India. At present (2021) there are 12 PSBs namely SBI, Bank of Baroda, Bank of India, Punjab National Bank (PNB), Indian Overseas Bank, Punjab and Sind Bank, Indian Bank, UCO Bank, Bank of Maharashtra, Central Bank of India, Canara Bank and Union Bank of India.

SBI and its Associates

SBI is the biggest commercial bank in the country with nearly 25 percent market share and has over 22000 branches and 58500 ATMs. SBI came into being on 1 July 1955 when the GoIpassed the State Bank of India Act, 1955 by taking over assets and liabilities of the Imperial Bank of India. Imperial Bank of India was formed in 1921 through the amalgamation of three presidency banks namely Bank of Madras, Bank of Bombay and Bank of Bengal. At present, SBI is a Fortune 500 company and is headquartered in Mumbai. SBI initially had 7 associates namely State Bank of Bikaner and Jaipur, Hyderabad, Indore, Mysore, Patiala, Saurashtra and Travancore. However, in 2008 and 2009 State Bank of Saurashtra and Indore was merged with SBI and the remaining 5 associate banks were merged in 2017.

Private Sector Banks

Private sector banks are those banks in which the majority of the stake is owned by private shareholders. In India, private sector banks are classified as Old and New private sector banks. The private banks which were not nationalized (in the year 1969) are collectively known as the old private sector banks and include banks such as The Jammu and Kashmir Bank Ltd., Lord Krishna Bank Ltd. etc. As of April 2021, the number of private sector banks in India was 22. Some of the famous private sector banks are ICICI, HDFC,etc.

Foreign Banks

Foreign banks are those banks which have headquarter in a different country but has branches in India. As of July 14, 2020, there are 46 foreign banks in India. These banks have to follow rules both of home and host country. Bank of America, Bank of Ceylon, National Australia Bank, BNP Paribas, etc are some of the foreign banks in India.

Regional Rural Banks (RRBs)

They were established in 1975 to develop the rural economy and creation of additional channel to the cooperative credit structure to enhance the reach of institutional credit for the rural and agriculture sector. There were 43 RRBs as of April 2021.

Scheduled Co-operative Banks

Cooperative banks function on the concept of cooperative credit societies wherein the members of the society join together to extend a loan to each other at a subsidised rate of interest. Scheduled Co-operative Banks are of two types Scheduled State Co-operative Banks and Scheduled Urban Cooperative Banks. There are 23 Scheduled State Co-operative banks and 53 Scheduled Urban Cooperative banks.

Narasimham Committee on Banking Sector reforms

Government of India set up two expert committees under the chairmanship of M.Narasimham for the restricting of Banking sector popularly known as Narasimham Committee-1 (1991) and Narasimham Committee-II (1998).

Activity 1

1. Suppose you are hired as an advisor to the finance minister and the country is witnessing a high rate of inflation. What advice would you offer regarding changing the policy rate like CRR, Repo Rate, etc. and why?

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2. The Govermnet of India is planning for more mergers of banks. How do you look about this decision?

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5.7 STRUCTURE OF CAPITAL MARKET

In the previous section, you have read about the money market which provides short term funds to investors for less than one year. However, business units and investors need funds for a longer duration also for undertaking business expansions or technology upgrading and in this regard they approach the capital market. A capital market is a market for long term securities or financial instruments having a maturity period of more than one year. Capital markets are important for channelising savings, capital formation and industrial growth. The structure of the capital market in India can be better understood with the help of Figure 5.4

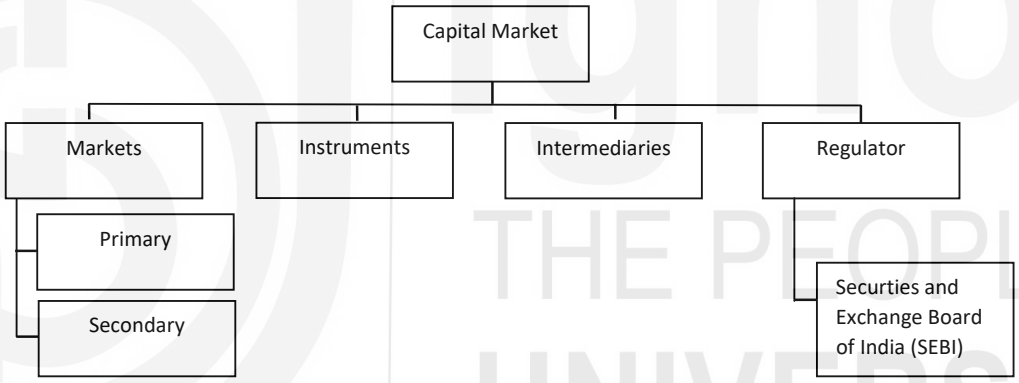

Figure 5.4: Structure of Capital Market in India

Capital markets comprised of two markets i) Primary Market and ii) Secondary Market. The primary market is also known as the New Issue Market (NIM) where the issuer of the securities (shares and bonds) sell the new securities to the investors directly without any intermediaries. Whenever the securities are offered for sale for the first time by the companies they are called Initial Public Offering (IPO). IPO is issued to raise capital for funding purpose. Both the companies and government raise funds by the sale of new stocks in the primary market.

The secondary market is also known as the stock market. It is a place where shares, bonds, options, etc which were sold earlier are sold and purchased. In India, you must have heard

about the Bombay Stock Exchange (BSE), National Stock Exchange (NSE) they are some of examples of stock exchanges. The secondary market can be either an auction market or Over-the-Counter. In the auction market, trading of securities is done through the stock exchange. In Over-the-Counter the trading is conducted without using the platform of stock exchange, it does not have any physical location and trading is done electronically.

Financial Instruments

Some of the major financial instruments used in capital markets are discussed below.

Shares

A share indicates a unit of ownership by the buyer of shares called shareholder/holers of the company. A shareholder has ownership in the company and has voting rights and shares the company profit or loss. The benefit which a shareholder receives out of company profit is called a dividend. Let us understand it with an example. Assume that there is a company know as XYZ limited and it needs funds (Rs 100 crore) for further expansion. For raising this fund the company will go to the public. This capital of Rs 100 crores is divided into 1,000,000 shares of Rs. 1000 per share. Now assume that there are two investors A and B and they want to invest in this company so they will buy some shares. Investor A buys 500 shares and investor B buys 800 shares so they are investing Rs 500000 and Rs 8000000 in this company and have become the shareholders and will share the profit or loss of the company in the proportion to their holdings. Further, shares are of two types namely equity shares and preference shares.

Bonds

Bonds are issued by state and central governments, companies and municipalities to raise money for a variety of projects and activities. They are debt instruments in which the entities borrow the funds for a defined period of time at a variable or fixed interest rate. It is fixed-income security and essentially a loan agreement between a bond issuer and an investor. The bondholders unlike shareholders do not have any ownership of the company or have voting rights.

Debentures

Debentures are also a type of debt instrument which is issued by companies for raising funds but they are not secured by physical assets or collateral. An investor buys debentures based on the reputations and the creditworthiness of the issuer. The interest rate on debentures is higher than that of bonds.

SENSEX also known as Sensitive Index (or S&P BSE Sensex Index) is a benchmark index of Bombay Stock Exchange. It is the market weighted stock of 30 companies.

Gilt Edge Market : The gilt-edged market refers to the market for Government and semi-government securities and is backed by the RBI. Government securties are called Gilt -edged means 'of the best quality' because they are highlighy liquid and risk free

Capital Market Intermediaries

There is a large number of intermediaries in the capital markets some of which are discussed below:

Merchant Bankers

Merchant Bankers are intermediaries between the investors and the company. They act as an advisor who advises the entrepreneurs from the stage of the conception of the project till the production begins. SEBI defines merchant bankers as "any person who is engaged in the business of issue management either by arranging for buying, selling or subscribing to securities or acting as manager, consultant or rendering corporate advisory services in relation to such issue management".

Underwriters

When a company decides to go public to raise funds all of its securities maybe not fully subscribed by the public, so there is a need for someone who can subscribe to those securities. This work is done by the underwriter he agrees with the issuer company that in the case of securities that are not subscribed then the underwriter would subscribe to the securities itself or by others the unsubscribed securities. He is paid a fee called 'underwriting commission' for this job. Underwriters can be both institutional (for example IDBI, UTI) or non-institutional. All underwriters need to be registered with SEBI.

Portfolio Managers or Portfolio Management Services (PMS)

A professional who enters into a contract with the client to advise or direct or undertake investment decisions on behalf of the client. Portfolio managers are of two types discretionary portfolio managers and non-discretionary portfolio managers. When the portfolio manager manages the funds of the client independently according to the needs of the client they are called discretionary portfolio managers. Whereas non-discretionary portfolio manager manages the funds following the directions of the client. Some of the examples of major **Portfolio Management Services** in India are Motilal Oswal PMS, Kotak PMS, ICICI Prudential PMS, etc.

Stock Brokers

A stockbroker is an individual or firm which is an intermediary between an investor and a securities exchange. The stockbroker trades in the stock exchange on the behalf of their clients. In return for their services, they are paid commissions of fees. They handle all the paperwork and maintain records of all transaction, manages their client's portfolio and advise the investors on formulating different investment strategies in the dynamic world of financial markets. All stockbrokers are registered with the SEBI.

Regulator of the Capital Market /SEBI

In India, the capital market is regulated by the Securities and Exchange Board of India (SEBI). SEBI was established in 1988 as a non -statutory body but with the passing of SEBI Act 1992, it was accorded statutory power. The major objectives of SEBI are to protect the interest of investors and development and regulation of stock exchange, to prevent deceitful malpractices and to regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc. SEBI performs various functions like registration of stock exchanges, mutual funds, underwriters, brokers and sub-brokers. Levys various fees and other charges promote investors educations, audit and inspection of stock exchanges and various intermediaries, prohibits unfair trade practices relating to the securities market and insider trading.

Activity 2

1. Conduct a field survey of your neighbourhood and assess the awareness level of the stock market.

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2. Nowadays there is a trend of investment among common man in Mutual Funds through Systematic Investment Plan (SIP). Try to collect some information in your neighbourhood about the factors which affect individuals decision to invest in MF.

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5.8 SUMMARY

This unit has given you detailed information about the financial system. Initially, you read about the importance of the financial system whereby it brings the suppliers and the borrowers of funds in the common platform. In the subsequent sections, the importance, functions and instruments of the money market were discussed. One of the major components of money markets is banks. In India, RBI is the apex bank and it formulates and regulates monetary policy. Monetary policy has two instruments namely quantitativeand qualitative. Quantitative instruments include various policy rates like CRR, Repo and Reverse repo rate, bank rate, etc. which aims at controlling the quantum of credit. Qualitative methods like moral suasion, direct action and others aim at directing the credit flow to a particular sector or to prohibit the credit flow. RBI uses both instruments but quantitative methods are more visible and easy to administer.

In the next section, you developed an understanding of banks and the various functions of the banks along with the structure of banking in India. The different categories of banks like the public sector, private sector, foreign banks were discussed in some details. In the last section, an understanding of the working of the capital market was highlighted with the emphasis on the meaning of capital market, its various instruments, intermediaries and SEBI.

5.9 KEY WORDS

Financial System: It consists of a set of institutions, instruments and markets which brings the savers and the investors to a common platform and provide the means by which savings are translated to investment.

Cash Reserve Ratio (CRR): It is the minimum amount that banks keep with RBI as a proportion of their Net Demand and Time Liabilities (NDTL).

Statutory Liquidity Ratio (SLR): It is the percentage of NDTL that banks have to mandatory maintain in safe and liquid assets like cash, gold or government securities.

Bonds: Bonds are issued by state and central governments, companies and municipalities to raise money for a variety of projects and activities.

5.10 SELF-ASSESSMENT QUESTIONS

1. Differentiate between money market and capital market.
2. Differentiate between shares and bonds.
3. What are the major functions of RBI?
4. Write about some of the instruments of the money market.
5. Write a note on SEBI.

5.11 REFERENCES/ FURTHER READINGS

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UNIT 6 INDUSTRIAL POLICY FRAMEWORK

Objectives

After reading this unit, you should be able to:

- trace the evolution of Industrial Policy in India;
- describe the framework of Industry Policy Formulation in India;
- identify the gaps in previous industrial policies and the need for New Industrial Policy;
- analyse the benefits and gaps of the present Industrial Policy;
- draw a comparison between State Specific Industrial Policies in India; and
- assess the importance of other policies supplementing the Industrial Policy.

Structure

6.1 Introduction
6.2 Industrial Policy Framework and Features
6.3 Stages of Industrial Policy Prior to1991
6.4 New Industrial Policy 1991
6.5 Analysis of the New Industrial Policy
6.6 State Specific Industrial Policies
6.7 Other Important Policies Focusing on Industrial Promotion
6.8 Summary
6.9 Key Words
6.10 Self-Assessment Questions
6.11 References/ Further Readings

6.1 INTRODUCTION

Industrial development is aimed to achieve economic prosperity and improving the lives of its people. India left no stone unturned to brace and strengthen its industrial development for which the quest started after independence in 1947. The initially conceived policy - The Industrial Policy Resolution of 1948 outlined and defined the role of the State in industrial development both as an entrepreneur and authority. For a stringent framework and better implementation of the Industrial Policy, enactment of Industries (Development & Regulation) Act, 1951 (referred as IDR Act) followed. This also allowed Union Government to direct investment into preferred areas of industrial activity through the mechanism of licensing and keeping abreast with national development objectives.

To fast-track industrialisation and to place India among global competitors, it was imperative to achieve sustainable growth, optimum utilisation of resources and growth in production with a focus on best possible utilisation of human resources and international competitiveness. To achieve sustainable growth, the policy explored prospects to deregulate

Indian industry while easing restrictions. Since 1991, economic reforms envisioned new and substantial role for private entities. In view of this, the policy has been progressively liberalized over the years. You will learn more about it in the following section.

6.2 INDUSTRIAL POLICY FRAMEWORK AND FEATURES

Indian economy was being built into a self-reliant and self-sustained unit with an aim to achieve industry-led-growth. The policy environment relied on import substitution, inward growth and subsidizations. Public sector in India soon witnessed a phenomenal expansion and economic prosperity.

However, it came to be afflicted with infirmities. At this point in time, it was realised that there was a need to make the public sector market-oriented. Hence, well-balanced improvements were needed to reformulate the policy accordingly. Public sector played a supportive role in the new policy framework but the initiative for growth was to be commenced from the private capital and enterprise. And so, the actual reformation started after 1995 and was influenced by three factors:

- Young entrepreneurs entered a competitive economy.
- Tariff rates started dropping down along with quantitative import restrictions becoming history.
- MNCs started entering India in greater numbers and created a competitive landscape from within.

Not just these factors but there are handful of other aspects that affected the industrial policy thereby impacting investment and production. Some of these were industrial licensing policy, control of monopolies and economic concentration, policies regarding technology import along with financial and fiscal policies affecting the provision of industrial finance, development of the capital market, as well as fiscal incentives/ disincentives to investment and production. It is in this context that we have to understand the evolution of industrial policy in India and know how it has worked as an effective tool to comprehend the objective of planned development. A look through the features of industrial policy will be focused upon.

6.3 STAGES OF INDUSTRIAL POLICY PRIOR TO 1991

The model of development and growth and the changes with time demands changes in economic policies and the need to create institutions for successful implementation of polices and to achieve growth. This means involvement of State is essential.

Industrial Policy and Strategy

From the time of Second Five Years Plan, Industry-led-growth strategy was a adopted and this strategy was based on the Industrial Policy Resolution (IPR) of 1956.

A number of changes had taken place during this time. So the IPR 1956 laid emphasis on the following:

- Fast-track expansion of heavy machine industry to lay the ground work for 'capital goods industries'.
- Involve private sector and make them co-partners.
- Expand heavy industry's base in the public sector.
- Promote and enhance growth of cottage and small scale industries by establishing large co-operative sector.

The IPR 1956 was commonly referred as the 'Economic Constitution' of India which established a base for cottage and small-scale industries and aimed to enhance their growth. A classification was made specifying industries into different groups while stating that both public and private sector was at the same time anticipated to be a part of the course of industrialisation in India. The demarcations of the industries were based on the following three schedules:

- **Schedule A:** Barring the industries for which permissions had already been given, 17 new industries to be set up by the State.
- **Schedule B:** Private sector industries - 12 in number to be set up with an aim to supplement the efforts of the State; and
- **Schedule C:** the developmental initiative was left entirely to the private sector except for the 29 above. Despite difference, it was always left open to the State to undertake industrial production in any of the areas keeping the national interest in mind.

Industrial Licensing

Industrial Licensing formed the backbone of State policy. The government initially insisted upon a written permission to an industrial unit allowing manufacturing of only those goods which were itemized in the permission letter was an important instrument which allowed the State to ensure that the manufacturing units follow the set of rules in place. The licence allotted to a manufacturing unit basically specified the whereabouts of the unit including site of the plant, merchandise to be manufactured, period within which the industrial capacity is to be established, etc.

The key objective behind licensing was the idea to work in unison or in agreement with the industrial policy. Any important alterations and modifications in industrial policy would need corresponding changes in the framework of Industrial Licensing.

The legislative framework for industrial licensing was represented in **three** different Acts:

- **Industries Development and Regulation (IDR) Act, 1951** – This was ordained to ensure that all industrial units obtain compulsory certificate of registration and new industrial units to be recognized as industrial units only after obtaining a license from the central government.
- **Monopolies and Restrictive Trade Practices (MRTP) Act, 1969** – The primary role of this framework was to control and curtail the concentration of economic

influence and discourage monopolies. It enforced restrictions on the acquisition and transfer of shares of, or by, certain corporate bodies, control monopolistic trade practices and restrict unfair trade practices. Another primary objective was to control monopolistic trade practices by promoting healthy competition.

... **Foreign Exchange Regulation (FERA) Act, 1973** –This was enacted to control the acquisition of foreign exchange or holding foreign exchange in any form. Basically, FERA 1973 was an extension of the Foreign Exchange Regulation Act, 1947. This Act empowered the Reserve Bank of India and the central government to ensure that foreign exchange earned by exports or otherwise are properly accounted for.

It was obligatory to take the permission from the Reserve Bank of India to carry out any trade activity either commercial or industrial in nature. Even the purchase of shares of any company required permission and this scrutiny was applied to any acquisition of any undertaking in India.

Phase of Liberalisation

Four decades after independence, the industrial landscape underwent a drastic change. The industrial policy's initial approach was to safeguard and protect the Indian industry during the initial stages of development and economic fluctuations. But this approach did not allow the industry to expand and adapt. Therefore, far-reaching expansions to the initial idea were made:

- **Mid-1970s Onwards:** During mid-1970's advancements and experimentations within internal trade witnessed liberalisation. This decade marked liberation from controls including an increase in license capacities and ease in licensing restrictions. Licensing policy underwent constant changes on complex features during 1970s and 1980s.
- **Mid-1980s Onwards:** To keep a check on fiscal, monetary and trade policies, industrial policy was reoriented and gained a push after the mid-1980s. Accelerated Growth and an improvement in domestic resources was the primary aim for this momentum.

Need for an Accelerated Growth: To meet the accelerated growth, expansions were made as follows:

- An improvement in imports meant improvement in production and hence imports was given attention;
- Amplified exports to pay for increased imports and avoid risks of heavy debt burden, a trait associated with large scale commercial borrowings;
- Progresses in terms of sharpening the competitive edge of exportable goods; and

- Revisions in industrial, trade and fiscal policies to increase benefit for exportable goods.

Domestic Resource Condition and the need to improve: There was an urgent need felt to improve the condition of domestic resources and there are few reasons listed below to understand why this was needed

- Government budgets were no longer enough sources of investment and finances.
- Any reduction in defence spending was not an option for the government;
- Subsidies can be reduced only at a slow pace to avoid any major social and political hitches; and
- Now the only way to raise additional funds was to make tax system more comprehensive and ensure that public sector enterprises generate more and more resources.

The above two proposals were immensely helpful in establishing the role of market and helping expand the concepts like broad banding, minimum economic capacity and de-licensing.

Moving further, let's keep in mind that the period beginning with 1985 witnessed development of rule based industrial policies. This included tax and tariff based interventions and dual pricing making direct price, output or capacity controls obsolete.

Activity 1

1. Briefly enumerate the key features of evolution of India's Industrial Policy.

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2. Briefly explain the framework for devising the industrial policy.

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6.4 NEW INDUSTRIAL POLICY 1991

By now when economic imbalances reached precarious levels, it was understood that the growth strategy pursued earlier was not sustainable as it led to deficit financing. A rise in Balance of Payments (BoP) deficit cannot be sustained with domestic resources. All these fluctuations led to a loss of foreign exchange capital and other funds and resources.

This was a call to adapt and modify while adopting measures to adjust budgetary deficits. The new amendments and sudden changes led to a slowdown of economy. What added to the problem were resource constraints in the public sector which could not provide the much needed support for demand creation. Hope for the revival of growth process was undermined due to the twin deficits - fiscal and BoP deficit.

This required immediate consideration and the government responded with a suitable set of macro-economic policies along with a new industrial policy. The new industrial policy was essentially based on the neo-classical paradigm which was designed to push growth and help restore macro-economic and financial stability.

A new set of policy structure and new objectives gave birth to a revised policy and a new industrial policy was announced on July 24, 1991. The principal objectives of the new industrial policy (NIP 1991) was to amalgamate the assets and advances gained during the four decades of economic planning over 1951-91 and ensure that the weaknesses majorly low productivity with high production costs are paid close attention. The new policy focussed on improving and maintaining a sustained growth in industrial productivity with ample employment opportunities. A major area of attention was to achieve international competitiveness. It was also emphasised that these objectives will keep a check on sustainability concerns vis-a-vis protection of environment and efficient use of available resources.

Alterations in Policy

This section will discuss the major changes in the NIP 1991 and the preceding changes:

a) **Industrial Licensing Policy:** With a new wave, Industrial licensing was eliminated for all projects excluding some industries. These industries were primarily those industries which were of security and strategic concern, involved in production of hazardous substances, leading to environmental degradation or destruction etc. Industries specifically cited to procure industrial licensing are:

- Distilleries and alcoholic drinks breweries;
- Defence equipment, electronic aerospace and defence aircraft
- Warships
- Aerospace substitutes;
- Industrial explosives including detonating fuses, safety fuses, gun powder, nitro-cellulose and matches.
- Tobacco products.

There were three more industry groups exclusively reserved for the public sector. These were recognised due to security and strategic concerns:

- Generation of atomic energy;
- Substances notified by the Department of Atomic Energy; and
- Railways (private funds permissible to limited amount)

There was no need for permissions and approvals from the central government for any other industries except for the ones mentioned above. However, it specified that locations of industries based on the level of pollution and distance from the cities with minimum thresholds of population.

b) Foreign Investment: The new wave witnessed new features, some of them are:

- Barring a few sensitive sectors, automatic approval is available to Foreign Direct Investment (FDI) in almost all sectors. The industries are classified into groups and automatic approval is available for up to 100 percent in specified industry groups.
- Companies which are involved in export of products, majority foreign equity holding of up to 51 percent will be allowed for an easy access to international markets.
- For the purpose of negotiations with international firms and for approval of direct foreign investments, a Foreign Investment Promotion Board was constituted.

c) Foreign Technology Agreements: For foreign technology agreements in high priority industries, automatic permission be given while on a lump sum payment of $ 2 million, 5 percent royalty for domestic sales and 8 percent for exports. This was subject to a total payment of 8 percent of sales over a 10 year period from the date of agreement or 7 years from commencement of production (Department of Industrial Policy and Promotion (DIPP).For all other industries - other than those specifically mentioned, automatic permission will be given subject to the same guidelines as in cases where no foreign exchange is required for any payment.

d) Public Sector: The new policy was a breath of fresh air for public sector. It was specified that public sector investments will be made in strategic areas. Public sector was given more freedom in terms of entering in areas not reserved for it. Also, reservations were made for the public sector. All those public enterprises which were

in a bad shape had to be referred to the Board of Industrial and Financial Reconstruction (BIFR) for revival schemes. Furthermore, attention was given to encourage wider public involvement in order to increase resources. A new view on shareholding was offered. In the public sector, apart of the government's shareholding was opened to mutual funds, financial institutions, general public and workers.

e) **MRTP Act:** The MRPT Act allowed more freedom in terms of removing pre-entry restrictions, prior approvals from the government for establishing a new undertaking or while getting involved in amalgamations or merging of industrial units. It also removed the threshold limits of assets in respect of MRTP companies and dominant undertakings.

6.5 ANALYSIS OF THE NEW INDUSTRIAL POLICY

With advancement and an entry into a new and a more liberalised era popularly referred to as economies of scale and quality, it was realised that the Indian industry has become far more unstable than earlier. The burden was mostly felt on the marginalised sections of the society. At this point in time, it was important to understand and focus specifically on the weaknesses of the new industrial policy and how the changes made it unstable and weak. Before we proceed, let's understand the strengths first.

Announcement of NIP 1991 opened up avenues and liberalisation got a robust push with major reforms but it was also realised that

- A suitable export policy was missing
- Distortions in investment patterns, some industries were booming while others were struggling with a slow pace of investments.
- A bond between new sectors with that of older ones was missing and thus there was a need realised in order to encourage modernisation and new product development.
- Modernisation, deviations and reformations often lead to displacement of labour. Labour displacement and rehabilitation issues were equally concerning.
- Lack of technological and innovative efforts intertwined with an absence of incentives based policy to encourage efficiency.
- Failure to designate or define a proper industrial location policy.
- Highly skewed income distribution and its related consequences

The **major strengths** of the new policy can be identified as:

- Changes in industrial licensing system were a major breakthrough and a key step towards liberalisation. Abolishment of extensive physical controls, lowering of taxes combined with better administration of revenue collection to attract investment were some of the best changes made to achieve growth. It also expanded the role of financial incentives in directing investments.

- For efficiency and to strengthen domestic firms, internal deregulation was encouraged. This is expected to inject much more competition in to the system, creating incentives for cost reduction.
- It also looked at strengthening legal framework with the formulation of Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. This act basically allows banks and financial institutions to enforce their claims on collateral for delinquent secured credit, without judicial intervention.
- At the same time, the Competition Act, 2003 prohibited anti-competitive practices and abuse of power through healthy competition and regulation of companies beyond a particular size.
- This in turn allowed internal liberalisation via open access to imports and other interventions such as technological advancement, modernisation and overall improvement in the industry with an aim to reduce costs and maintain a progressive environment.
- Although the system was in pressure to maintain, efficiency, advancement and adapt to modern technological solutions but the rationale to justify this was the view that pressure commensurate with the ability of the system to respond helps maintain efficiency. However, pressure beyond one's ability will only be disruptive.

All in all, the aim of the policy changes aimed to introduce an integrated economic package and to create a suitable environment for promotion of efficiency, productivity and industrial growth through a well-coordinated structure.

Activity 2

1. Briefly state the key features of New Industrial Policy.

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2. Briefly enumerate the pros and cons of New Industrial Policy.

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6.6 STATE SPECIFIC INDUSTRIAL POLICIES

With technology and innovation, India is catching up with its global counterpart while pioneering business models and strategies. The state governments have shown immense progress. Policies of states in Southern region are a perfect example of how consistent compliant policy helped the region in developing private enterprises and making investments beneficial while nurturing MSMEs. This helped in curtailing unemployment at a drastic rate. The state specific industrial policies have focused on simplification and developments in the following areas:

- Single window clearance
- Labour regulation
- Online tax return filing
- Inspection reform
- Commercial dispute resolution
- Availability of land
- Construction permit
- Access to information and transparency
- Obtaining electricity connection
- Environment registration

A Brief Comparison of State specific Policies is outlined below:

State	Policies adopted
Andhra Pradesh	... Single Window System to setup industry within 21 days ... Spot Registrations under Professional Tax, Registration of Shops and Establishments Approval on self- certification ... Incentive for Subsidisation of GST, Stamp Duty ... Simplification in Land Allotment and Labour Laws ... Setting up of Skill Development Centres
Karnataka	... Registrations/ approvals of 10 departments provided online ... Commercial Tax related Services provided Online ... Online Information on Availability of Land in Industrial Areas ... Timelines fixed for providing most of the Industry related Services ... Property Registration fully Computerized ... Online Consent for Establishment

	... Online Project Monitoring System for Tracking the Application ... Interest free Loans ... Exemption of Stamp Duty ... Concessional Registration Charges ... Setting up of Skill Development Centres
Kerala	... Single Window Clearance for Industrial Units ... Setting up of Industrial Development Zones ... Incentives only to New Entrepreneurs ... Relocation of Industries to Mitigate rising Pollution ... Eco-friendly Transportation Modes ... Allotting of Land through Government Portals ... Encouragement of Women Entrepreneurs ... Employing Skilled Labourers
Puducherry	... Single Window Application has been developed Online ... Interest Subsidy ... Fixed Power Cost ... Environment Related Reforms ... Skill Development
Tamil Nadu	... Single Window Facilitation for Pre- project Clearances ... Employment Intensive Subsidy ... Environmental Tax Reforms ... Skill Development
Telangana	... Strengthening of Existing Single Window Clearance System ... Reimbursement of 50% net VAT/CST or SGST ... Women owned Enterprises Additional 10% Investment Subsidy ... 25% Subsidy on specific cleaner Production Measures

The above comparative analysis helps in understanding the initiatives of various states in terms of industrialisation and thus also suggests way forward for other states to devise and implement industrial policies in each state.

Case-1

The state of Tamil Nadu is an example to look and learn from. This is one state which can boast of an impeccable infrastructure in terms of road and railway connectivity. With 3 major and 23 minor ports along with 7 airports, Tamil Nadu also has the most prosperous automobile industry reflecting on how it is an epitome of effective government policy.

According to the Annual Survey of Industries Report, there is three digit raise in employment rate between 2007-2008 and 2014-2015. Their manufacturing of motor vehicles, trailers and semi-trailers, saw a 170 per cent increase in the same time period. The state has a remarkable share of employment which saw a jump from 7 per cent in 2007-2008 to 12 per cent in 2014-2015.

Building of Automotive Suppliers Parks and new auto cluster districts was a smart move which helped create auto cities, design and tech parks and logistics hubs while keeping a check on costs. This highlighted how shared facilities and technological advancement help in growth and building sustainable models to enhanced growth in the sector. The government is involved in developing two major corridors namely Chennai-Kanyakumari corridor with an aim to spur growth across the state.

6.7 OTHER IMPORTANT POLICIES FOCUSING ON INDUSTRIAL PROMOTION

India being an agriculture based economy has built and helped evolve small scale enterprises and is known across Asia and the world for building the most elaborate development programmes for small enterprises and for providing assistance both on an individual and institutional level. These developmental programmes are not confined to certain areas but have been rolled out both for urban as well as rural settings.

With an era of advancement during the post-reform period, the focus shifted to promotion and up gradation. The quest for promotion demanded modernisation of Small Scale Industry (SSI) units, an improvement in quality of output and technological advancement which needed massive funding. Therefore, access to technology, finances and innovation were few pre-requisites to sustain competition.

Moreover, access to marketing opportunities and assistance in marketing are key requisites apart from these three core areas - quality, finance and technology. So, a broad policy package was announced for small-scale industry in March 1994. These new sets of policies were based on the recommendations of S.P. Gupta Committee with inputs from others in June 1998. The success of the new SSI policy was intertwined with many other linked schemes such as quality control, technology up-gradation, introduction of better marketing schemes besides single window clearance scheme for composite loans, etc.

To ensure this, various other policies played an important role. The Competition policy was an important intervention to ensure healthy competition and promotion of SSI's.

Competition Policy

As discussed earlier, there were many constraints on competition in the pre-reforms era:

- Apply for and procure license which restrained investments;
- Restrictions to enter for new enterprises;
- There were restrictions on acquisition of economic control through MRTP;
- Widespread monopolies due to reservation for public sector and other industries;
- Small scale industries were under constraints of product reservation;
- High tariffs and other policy interventions to restrict trade.
- Foreign direct investments were under strict scrutiny.

For a healthy competitive environment and to ensure efficient production, two factors were recognised as vitally important. **One** was to allow Indian players become independent and competitive globally and **second** was to create an accessible atmosphere in the domestic market. This was introduced to help increase competitive edge of Indian players and boost competitive strength of Indian economy.

To achieve this, encouraging competition to achieve efficiency, better allocation of resources and at the same time ensuring consumer well-being was the key. This can be achieved only when other policies and laws are in sync.

To bring the different aspects of economic growth and to ensure strong market presence, a single law was much needed which could help bring mutually supporting laws, other economic policies and institutional structures under one umbrella including those relating to FDI, infrastructure and international trade.

It was realised that there was an urgent need to promote competition in view of the international developments. This necessitated comprehensive design, thinking and a policy structure in place. So, under the chairmanship of Shri S.V.S. Raghavan, the Government of India set up a nine-member committee in October 1999 to recommend a judicial and administrative framework.

On recommendation of the expert committee, the government passed the Competition Act, 2003 replacing the MRTP Act. This came into existence with a key aim of supporting and promoting competition while prohibiting anti-competitive practices.

The Competition Commission of India (CCI) was soon established and set up under the Competition Act, 2003 with an aim to promote spirited competition while preventing abuse of dominance.

Some major **objectives** of the Competition Commission of India are:

- To stop practices which adversely affect competition
- Encourage and endure competition in market
- Ensure quality of products and services is up-to mark.
- Consumer welfare
- Allow freedom of trade in the markets of India

For CCI to work as a market regulator, other bills were passed such as the Competition Amendment Bill (2007).

It was laid to ensure

- good quality products and services are available
- promote fair and healthy competition

- easy and fast mergers and acquisitions
- regulation of acquisitions and mergers within the threshold limits
- preventing abuse while allowing control

Despite concerns, the new competition law in India is based on a robust competitive market model which is consistent and in sync with fresh competition ready to meet the new challenges. India appears to have taken a significant step but the measurement of success depends on implementation.

The Special Economic Zone (SEZ) Act, 2006

The Special Economic Zone (SEZ) Act, 2006 emphasised on the development of specific areas for promoting manufacturing and exports. The main incentives are:

- Duty-free import of capital goods, raw materials, consumables and spares
- Tax exemption on export profits for the first five years
- Exemption from minimum alternate tax (MAT)
- Goods purchased from domestic tariff area (DTA) are exempt from sales and service tax
- Exemption from stamp duty, registration fee and electricity duty
- No tax on income from dividends and long-term capital gains tax
- 100% FDI allowed for developers.

Activity 3

1. Briefly enumerate State Specific Industrial Policies.

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2. Briefly explain the importance of other policies supplementing industrial policy framework in India.

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6.8 SUMMARY

India opted for Industrial development and initially conceived the Industrial Policy Resolution, 1948. Industries (Development & Regulation) Act, 1951 (referred as IDR Act) was also enacted to keep abreast with national development objectives. To achieve sustainable growth, the policy explored prospects to deregulate Indian industry while easing restrictions. Since 1991, economic reforms envisioned a new and substantial role for private entities. Since Industrial Policy Resolution (IPR) of 1956, Industry-led-growth strategy was adopted and led to involvement of private sector, expansion of heavy industry's base in the public sector and further promoting and enhancing growth of cottage and small scale industries by establishing large co-operative sector.

In 1991 when economic imbalances reached precarious levels, it was understood that the growth strategy pursued earlier was not sustainable as it led to deficit financing. A new set of policy structure and new objectives gave birth to a revised policy and a New Industrial Policy, 1991. The principal objectives of the New Industrial Policy (NIP) 1991 was to amalgamate the assets and advances gained during the four decades of economic planning over 1951-91 and ensure that the weaknesses majorly low productivity with high production costs are paid close attention. The new policy focused on improving and maintaining a sustained growth in industrial productivity with ample employment opportunities. With technology and innovation the state governments have shown immense progress. Southern region is a perfect example of how consistent compliant policy helped the region in developing private enterprises and making investments beneficial while nurturing MSMEs. This helped in curtailing unemployment at a drastic rate. With an era of advancement during the post-reform period, the focus shifted to promotion and up gradation. The quest for promotion demanded modernization of SSI units, an improvement in quality of output and technological advancement which needed massive funding. Therefore, access to technology, finances and innovation were few pre-requisites to sustain competition. Moreover, access to marketing opportunities and assistance in marketing are key requisites apart from these three core areas - quality, finance and technology.

6.9 KEY WORDS

Broad-banding: This was one concept introduced to give flexibility to licensed units. Under this, the product-mix within the overall ceiling was sanctioned to licence holders.

Minimum Economic Capacity: An efficient scale of production was recognised - production at a scale which allows overall low average costs. More generally, there was no ceiling but only a threshold floor level prescribed.

Delicensing: Exempted from licensing requirements.

Public Sector: It includes public goods and governmental services such as the military, law enforcement, infrastructure, transport, education, healthcare, etc.

Tariff Rates: A tariff is a tax imposed by a government on goods and services imported from other countries that serves to increase the price and make imports less desirable, or at least less competitive, versus domestic goods and services.

Monopolies: A monopoly refers to when a company and its product offerings dominate one sector or industry.

Liberalisation: Removal or reduction of restrictions or barriers on the free exchange of goods between nations.

Single Window Clearance: It is a trade facilitation concept which allows to provide information required by various official agencies via one regulatory body.

Small Scale Industries: Those industries in which the manufacturing, production and rendering of services are done on a small or micro scale. These industries make a one-time investment in machinery, plant, and equipment, but it does not exceed Rs. 10 crore and annual turnover does not exceed Rs. 50 crore.

Special Economic Zones (SEZs): An area in a country that is subject to different economic regulations than other regions within the same country. The economic regulations of Special Economic Zones tend to be conducive to—and attract—Foreign Direct Investment (FDI)

Domestic Tariff Area: An area within India that is outside the Special Economic Zones and EOU/EHTP/STP/BTP. The units operating under certain specific schemes such as EPZ/SEZ/EOU are expected to carry out their activities within a customs bonded area.

Foreign Direct Investment (FDI): FDI is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company.

The Goods and Services Tax (GST): GST is a value-added tax levied on most goods and services sold for domestic consumption. The GST is paid by consumers, but it is remitted to the government by the businesses selling the goods and services.

6.10 SELF-ASSESSMENT QUESTIONS

1. Critically compare the pre and post New Industrial Policy 1991 in India.
2. Give a roadmap for adoption of State Specific Industrial Policies by all states of India.
3. Suggest changes in the present trade and industrial policy of India to ensure adequate growth of the country.

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UNIT 7 AGRI-BUSINESS ENVIRONMENT

Objectives

After reading this unit you should be able to:

- analyse the trends in agricultural production, sales and exports in India;
- explain the framework of evolution of Farm Policies in India;
- analyse the Farm Reforms 2020;
- identify the gaps and key players in the Agriculture Sector;
- draw a comparison between State Specific Industrial Policies in India; and
- assess the role and importance of Agriculture Marketing.

Structure

7.1 Introduction
7.2 Trends in Agricultural Production, Sales and Exports
7.3 Evolution of Farm Policies in India
7.4 Farm Reforms 2020
7.5 Key Players in the Agriculture Sector
7.6 Role and Importance of Agricultural Marketing
7.7 Summary
7.8 Key Words
7.9 Self-Assessment Questions
7.10 References/ Further Readings

7.1 INTRODUCTION

Since independence, the agricultural sector has witnessed a mixed path withsignificant progress in agricultural development in India. The progress can be witnessed through increase in crop production, productivity, diversification, and technological developments. During the initial years, there were some hiccups and growth stagnated. However, since the mid-1960s, growth rate started moving up and gained momentum especially during the mid-1980s but started losing the pace in 1990s and this was tilted towards foodgrains to address the issue of food security. In recent years for those dependent on agriculture as a key source of livelihood, it is turning un-sustainable in terms of economic and social consequences - majorly agrarian crisis with a sweepingmigration to the cities and farmers' suicides etc.This cast doubt on the future growth prospects of the Indian economy, which is majorly dependent on the growth performance of agriculture.Besides, our import needs are well-established when it comes to essential food products such as pulses and edible oils.

So, to understand the various trends and factors responsible in shaping India's agricultural landscape, it is essential to know the economic reforms and regeneration with a sustained and broad-based agricultural development. This calls for an understanding of the factors that may

have contributed to shaping past trends and will also help in designing the future strategy of development. This unit brings forth some of the important issues in order to understand the agriculture environment in detail.

7.2 TRENDS IN AGRICULTURE PRODUCTION, SALES, AND EXPORTS

More than half of the country is reliant on agriculture since it is the prime source of living and employment for about 58% of Indian population. The latest data highlights that growth in Gross Value Added (GVA) in agriculture and allied sectors stood at 4% in 2020. Considering this, the Indian food industry is on the threshold of massive growth, increasing its contribution to world food trade every year. The food industry has a huge potential for value addition with a bright prospect, where the food processing industry where the Indian food processing industry accounting to 32% of the country's total food market.It is one of the largest industries in India and is ranked fifth in terms of production, consumption, export and expected growth (IBEF 2020).

Currently, the food and grocery market in India is the sixth largest globally, with retail contributingto 70% of the sales and the agriculture, forestry and fishing growth is predicted to be 3% in the 2021.

India is one of the leading exporters of agricultural products globally. The food grain production was estimated to reach a record 295.67 million tonnes (MT) during the year 2019-20 and the government has set a higher food grain production target in 2020-2021. According to Indian Sugar Mills Association (ISMA), the production of sugar in India reached 26.46 MT between October 2019 and May 2020 whereas horticulture crops in India stood at a record 320.48 million metric tonnes (MMT) in 2020.The organic food sector is pacing at an advanced rate andis expected to reach Rs. 75,000 crore (US$ 10.73 billion) by 2025.

Various government initiatives, investments and interventions have helped the Indian food processing industry to attract Foreign Direct Investment (FDI) inflow. The business has attracted US$ 10.20 billion between April 2000 and September 2020 according to the figures released by Department for Promotion of Industry and Internal Trade (DPIIT). Few other initiatives in the sector that helped boost growth are subsidiaries in agricultural loans, introduction of forest fresh organic products, Pradhan Mantri Fasal Bima Yojana which collates data infrastructure for farmers. Another initiative is the introduction of animal husbandry infrastructure and launch of National Animal Disease Control Programme (NADCP), which aims to eradicate foot and mouth disease. Launch of various mega food parks including one in Punjab, launch of PM Matsya Sampada Yojana, e-Gopala App and several initiatives in fisheries production, dairy, animal husbandry and agriculture, along with a Transport and Marketing Assistance (TMA) programme to provide financial support for transport and marketing of agriculture products (IBEF 2020).Other major intervention was the approval of the Agriculture Export Policy, 2018 which aims to increase India's agricultural export to US$ 60 billion by 2022. Enhancing the aptitude of food processing

sector in India and allowing 100% FDI in promotion and marketing of food products and in food product E-commerce under the automatic track are other major interventions to escalate productivity and growth.

There have been many notable achievements in the sector such as in line of mega food parks and other sectors. Of the total 37 food parks, 21 mega food parks are operational, coffee export has shown promising results and stands at US$ 742.05 million in 2020 while tea exports stand at US$ 709.28 million in FY20. After the launch of Electronic National Agriculture Market (e-NAM) in April 2016, more than a thousandmarketplaces (mandis) are linked to e-NAM. This was an initiative to create anintegrated market for agricultural products.

The farming and food production in India is expected to fast-track its pace of growth in the coming years and is expected to achieve its aspiring aim of amplifying farm income by 2022. This has become possible because of increased investment in agricultural infrastructure such as irrigation facilities, ware-housing and cold storage. An overall increase in usage of genetically modified crops will likely improve the yield for Indian farmers with the help of concerted efforts of scientists. Self-reliance in pulses in next few years with the help of minimum support price will be another step. Other areas focussing on adoption of good manufacturing, food safety and quality assurance mechanisms is essential for development and enhancement. This will immensely help in achieving Quality Management and Good Hygienic Practices by the food processing industry and will in turnopen more avenues and offer benefits.

7.3 EVOLUTION OF FARM POLICIES IN INDIA

Legislative powers are distributed between the centre and the states through the Seventh Schedule of the Indian Constitution. Agriculture is part of the State List therefore only individual states have the power to legislate on such matters, but the Central Government has residual powers.

Domestic Agricultural Policies

1947-1965

During the initial years, achieving self-sufficiency was the primary objective of India's agricultural policies which was aimed to improve food security. Since the principal aim of the land reforms was to get rid of challenges imposed by middlemen with an improvement in production while focussing on establishing worker ownership and equity in rural society. In view of this, the first major reform that was enacted by the states post-Independence was the Zamindari Abolishment Act (1950s). To place an upper limit on the size of agricultural land holdings, establishing state control on vacant lands and to distribute the acquired idle land to the disadvantaged rural population was established to provide security to the renters.

1965-1980

The era marked Green Revolution, launched in 1965. It focussed on using innovative techniques and increasing crop productivity with the help of technology. India started importing high yielding varieties (HYVs) of wheat and rice and adopted improved pesticides, fertilisers and irrigation methods which led to increased food grain production. For further amendments, the government set up important institutions in 1965. One was the Commission for Agricultural Costs and Prices (CACP) previously called the Agricultural Prices Commission and the Food Corporation of India (FCI).

To lend money to farmers and increase lending by enhancing flow of credit to the agriculture sector, new financial institutions including the National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRBs), were set up and 14 largest commercial banks were nationalised in 1969 in view of this.

1980-1991

The focus was on improving crop production during the Green Revolution, so the corresponding years focussed on expansion in the use of green revolution technologies to other crops and regions. As agricultural output rose, production began to diversify into high value commodities, such as fish, poultry, milk, fruits, and vegetables.

1991 onwards

The agricultural reforms lagged the general economic reforms but over time the policies regulating agricultural trade were relaxed. A major step was the transition from the Public Distribution System (PDS) to the Targeted Public Distribution System (TPDS) in 1997 aimed to ensure that impoverished people get access to food at subsidised prices. In July 2000, the Government of India announced the country's first ever National Agriculture Policy (NAP). This policy aimed at achieving a growth rate more than 4% per annum in the agriculture sector. The objectives of this policy were to create employment opportunities for rural population, accelerate the growth of agro businesses, explore and realise the massive untapped growth potential of Indian agriculture, promote better standard of living for rural population, discourage relocation from rural to urban population and to overcome the trials arising due to economic reforms of 1991.

Marketing Policies

The National Policy for Farmers (NPF) approved by the Government in 2007 recognized a need to emphasise on increasing farmer's incomes along with production. The five-year plans also recommended policy initiatives to enhance the working of the agricultural sector. The National Food Security Act (NFSA) was enacted on 12 September, 2013 with the objective to provide for food and nutritional safety by guaranteeing access to a good amount of quality food at affordable prices.

Essential Commodities Act (ECA)

An earlier amendment to the Indian Constitution granted the Union Government a statutory right to standardise and regulate the production, pricing, and delivery of essential commodities.

The most fundamental policy instrument is the Essential Commodities Act, 1955 (ECA), which aims to control production, supply, distribution, and pricing of essential commodities to ensure that essential commodities are made available to the consumers at fair prices. Under this Act, Centre and State Governments have the power to impose stock limits on the identified commodities to prevent hoarding. They can also direct a stockholder to compulsorily sell their stock to the government, regulate prices and ban the holding back of a product or good for sale.

Agricultural Produce Market Regulation Acts (APMC)

During the 1960s and 1970s, most of the states passed Agricultural Produce Markets Regulation (APMR) Acts. These Acts are popularly called the APMC Acts since they regulate markets through Agricultural Produce Market Committees (APMCs). A State's APMC Act authorizes the state to set up regulated wholesale markets (mandis or APMC markets) for agricultural products. The APMCs have the power to controlagricultural markets and regulate all features of marketing, including the imposition of a mandi tax for trade taking place both on and off the wholesale markets.

The Act covers the entire state and makes these mandis the required channel for trading farm produce, and does not allow private players from setting up markets. In 2003, the Ministry of Agriculture created a model APMC Act and circulated into the states so that they could modify their individual acts. This was followed by the model APMC rules in 2007.

Minimum Support Price

The pricing policy defined in the ECA and APMC Acts aims to ensure that farmers receive lucrative prices for their produce while also ensuring that it is affordable for consumers. In order to do so, the central government sets a Minimum Support Price (MSP) for 24 crops every year. The FCI and several state level agencies working in support of the FCI are required to procure the specified commodities from farmers at the notified prices (MSP). But this mechanism operates effectively only for a few commodities (primarily for wheat, rice and cotton) and only in a few states. A large number of farmers are required to tradewith other buyers at prices lower than the specified MSP, especially in eastern India due to ineffective procurement and lack of alternative buyers.

Activity 1

1. Briefly enumerate the key trends in India's Agri-Business Environment.

2. Briefly explain the framework for evolution the farm policies in India?

7.4 FARM REFORMS 2020

On 27th September 2020, Ram Nath Kovind, the President of India gave his acceptance to the 3 farm bills that were earlier passed by the Indian Parliament. These Farm Acts are as follows:

Farmers' Produce Trade and Commerce (Promotion and Facilitation) Act, 2020

This Act permits farmers to sell their produce outside the APMC regulated mandis but it does not abolish them. It aims to provide lucrative prices to farmers via alternative trade channels. It also prohibits state governments from imposing any tax on the trade of produce outside the mandis.

Farmers' (Empowerment and Protection) Agreement on Price Assurance and Farm Services Act, 2020

It creates a national framework for contract farming. Although contract farming was legal prior to the enactment of this act as well, this act aims to provide a completecomprehensive outline for such an arrangement. This will enable farmers to contract a guaranteed price for their produce prior to production/sowing.

Essential Commodities (Amendment) Act, 2020

The ECA has been amended to state that the Government of India will list few commodities as essential and control their supply and prices only in cases of war, famine, extraordinary price rises, or natural calamities. Other produce including cereals, pulses, potato, onion, edible oilseeds, and oils have been deregulated. The amended act also states that the government will impose stock limits on essential commodities only when the rise in price is at least 100% for horticultural produce and 50% for non-perishable agricultural produce.

The enactment of these acts has created fear in the minds of farmers and has led to widespread protests. Despite several rounds of talks, the government and the farmers have not been able to arrive at a mutually agreeable solution. The farmers fear that increased private sector participation will lead to exploitation and that their interests will not be safeguarded. Although the government has made several attempts to pacify the farmers, they have all been in vain.

Activity 2

1. Briefly enumerate the key features of India's new farm policies.

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2. Briefly compare the old agricultural policies with farm laws 2020.

7.5 KEY PLAYERS IN THE AGRICULTURE SECTOR

With growth and increase in production, the active role of middlemen in the movement of agricultural commodities which specialise in performing marketing roles and are involved in marketing of products has increased. The number of mediators can be classified into five groups as follows.

- Merchant Middlemen
- Agent Middlemen
- Speculative middlemen
- Processors
- Facilitative Middlemen

Merchant Middlemen

Merchant middlemen are the ones who take title of the goods they deal in while buying and selling. Their earningor loss depends on the sale and purchase prices. They are of **four** types:

a) **Wholesalers**: Those who buy agricultural commodities in large quantities directly from farmers or from other wholesalers. They mainly assemble the goods from

various localities and store produce and often release them in the off-season since they store them in the peak arrival season.

b) **Retailers**: They buy from wholesalers and sell it directly to consumers in small quantities. Retailers are the closest to consumers in the marketing channel.

c) **Village merchants:** The vendors or retailerswho move from village to village to directly purchase the produce from the cultivators. Village merchants purchase the produce of those farmers who have either taken finance from them or those who are not able to go to the market. Village merchants also supply essential consumption goods to the farmers. They often act as the financers of poor farmers and sell the collected produce in the nearby market or the villages.

d) **Mashakakhores:** It is a colloquial term for big retailers who often act as small wholesalers and majorly deal in fruits and vegetables. They usually sell to bulk consumers like hotels, para-military units or small retailers/vendors. Over the years, they have started dealing with all types of customers without the condition of a minimum quantity and are working like ordinary retailers.

Agent Middlemen

They are basically representatives of clients and do not own the products. They act as negotiators between sellers and buyers and help them in sale and purchase of products. They usually receive commission or brokerage on sale. Agent middlemen are of **two** types:

a) **Commission Agents:** A commission agent generally operates in the wholesale market and acts as the proxy of either a seller or a buyer by representing them in buying and selling of products.
b) **Brokers:** They act as communicators between buyers and sellers to bring them on the same platform while facilitating personal services to their clients in the market. They may claim brokerage from buyer, sellers or both depending upon the market situation as they simply wander to render their services to clients.

Speculative Middlemen

These middlemen are the ones who buy products at a low price when arrivals are sizable usually in off-season when prices are high. They take claim of the product and risk associated with anaim to make a profit on it.

Processors

Processors are the ones who hire agents to buy for them from areas where production is high either and bring on their businesses either on their own or on custom basis. Agents may also store the products and may deal with it throughout the year on continuous basis. They often

are involved in advertising to generate demand for their managed goods and add form utility to farm goods.

Facilitative Middlemen

As the name suggests, these middlemen facilitate buying and selling while assisting in the marketing process. Theyget their income in the form of fees or service charge since most of them are labourers who help in physical movement of goods and products while loading and unloading them. Weighmen and graders also fall into this category since they facilitate weighing of produce and grade products according to different categories. They are often termed as thecore of the marketing wheel.

Transporters who assist in movement of the produce from one market to another and communication agencies including advertising agenciesthat majorly help in decision making about the purchase of goods are a part of this group. Auctioneers who help in exchange of produce by putting the produce for public sale and bidding by the consumersor buyers are equally important and help in ironing out the marketing system.

7.6 ROLE AND IMPORTANCE OF AGRICULTURAL MARKETING

Agricultural marketing has a vital role as it helps in encouragingthe process of production and consumption. It equally helps in accelerating the pace of fiscal developmentsince it is an important multiplier of agricultural development.

A shift from traditional to modern agriculture system has been a challenge and marketing has been a big experiment in the entire process. But the role of marketing remains utmost important. The importance of agricultural marketing is revealed from the following.

Optimization of Resource use and Output Management

The key role of an efficient marketing system is to help the market in pulling down the losses and accelerating the marketable surplus. The marketing losses often arise due to inefficiency in processing, storage and transportation of products. An efficient marketing wheel will help in optimization of resources and output management and a well-thought out system of marketing can help in even distribution of available stocks. Taking everything into account, it is indeed a modern approach to sustainable growth and sustains it.

Increase in Farm Income

Reducing the number of middlemen while ensuring higher level of income to restrict the cost of marketing services and the malpractices is what a good marketing system would aim at achieving. An efficient system assures improved prices for farm products and encourages them to invest their surpluses in buying modern inputs so that yield and produce may increase.

Widening of Markets

When a system widens the market by taking the products to remote corners both within and outside the country is considered profitable since it increases the demand on a continuous basis while guaranteeing a higher income to the producer.

Growth of Agro-based Industries

Agri-dependant industries rely on the supply of raw materials such as cotton, sugar, edible oils, food processing and jute on farm produce and therefore require an efficient system to help in the growth to encourage the overall development process of the economy.

Price Signals

Efficient marketing systems allow farmers in scheduling and arranging their production in accordance with the needs of the economy. This work is carried out through transmitting price signals.

Adoption and Spread of New Technology

Adapting to demands and adopting latest technologies and scientific knowledge always leads to growth. But a technology upgrade requires greaterinvestment and farmers would invest only if they are guaranteed of ago-ahead at remunerative price.

Employment Creation

This is a system of marketing which focuses on employment generation and engages millions of people in activities, such as wrapping, packing, transferring, storing and doling out.

Persons like commission agents, brokers, traders, retailers, weighmen, hamals, packagers and regulating staff are directly employed in the marketing system. Apart from them, several others are able to look for employment opportunities when dealing with supply of goods and services.

Addition to National Income

Marketing events are value additions to the product since they increase the nation's gross national product and net national product.

Improved Living

Development that adds togrowthwhile diminishing poverty of the populationand adds to foreign exchange while eliminating economic waste should be given special attention. The development of an efficient marketing for food and agricultural products is also vital to overall economic development. The marketing system is the key for the success of the development programmes which are aimed to uplift people.

Activity 3

1. Briefly enumerate the key stakeholders in the Agriculture Sector in India.

2. Briefly explain the importance of agricultural marketing.

7.7 SUMMARY

The agriculture sector in India has come a long way since Independence in India. With initial roadblocks post independence to major reforms in 1960s which escalated growth to a downfall in mid 1980s and 1990s to a shift in production pattern to food grains to cater to growing food security issues. Majority of the population in India depends on the agrarian sector as a prime source of livelihood but shift in patterns of employment and migration to cities has caused a doubt on the growth prospects of Indian agriculture sector. In 2020, it was seen that 58% of India's population depends on agriculture as the primary source of livelihood and growth of the sector stood at 4 percent. India is one of the leading exporters of agricultural products globally. A number of government initiatives, investments and

interventions have helped the Indian food processing industry to attract Foreign Direct Investment (FDI) inflow. In the coming years, the Indian agricultural sector aims at doubling farm income and introducing better infrastructural facilities for irrigation and storage. The minimum support price also aims at making each sub sector of the agricultural sector self sufficient.

From 1947-1965, achieving self sufficiency was the key objective and thus improving food security along with abolishing of the Zamindari System. In 1965, Green Revolution was launched and a number of innovative techniques, irrigation methods, pesticides and setting up of key institutions were introduced. To strengthen flow of credit to the agricultural sector, Banks were nationalised and new financial institutions were set up specifically for the agricultural sector. In the 1980s, production in the agricultural sector diversified to high value commodities like poultry, fisheries and dairy. In 1997, a major step was the transition from the Public Distribution System (PDS) to the Targeted Public Distribution System (TPDS). The National Agriculture Policy was announced in July 2000 in order to create employment opportunities for rural population, accelerate the growth of agro businesses, explore and realise the massive untapped growth potential of Indian agriculture, promote better standard of living for rural population and to discourage relocation from rural to urban population. In 2007, National Policy for Farmers (NPF) and in 2013 National Food Security Act (NFSA) was enacted. These acts helped in increasing farmer incomes and guaranteeing nutritional security by regulating food prices.

The agriculture sector has been well protected by the Essential Commodities Act , 1955 according to which government controls the production, supply, distribution, and pricing of these commodities to ensure that they are made available to the consumers at fair prices along with the APMC Act regulated by states. In 2020, new farm reforms were enacted and now farmers are permitted to sell their produce outside the APMC regulated mandis but it does not abolish them. It aims to provide lucrative prices to farmers via alternative trade channels. A national framework for contract farming has also been introduced. The Essential Commodities Act was also amended in 2020 and it states that certain commodities will be listed as essential and government will regulate their supply and prices only in cases of war, famine, extraordinary price rises, or natural calamities. Several commodities including cereals, pulses, potato, onion, edible oilseeds, and oils have been deregulated.

To increase production of agricultural commodities, a number of players/middlemen have emerged over the years. Only enhancing production will not be of any help, hence agricultural marketing as a concept has picked up pace. These intermediaries are primarily Merchant middlemen acting as wholesalers, retailers, Village merchants and Mashakakhores. Then there are agent middlemen who cater to activities like negotiations between buyer and seller for commissions. Speculative middlemen buy products at a low price when arrivals are sizable usually in off-season when prices are high. Processors are the ones who employ agents to buy for them from areas where production is high either and carry on their businesses either on their own or on custom basis. Facilitative middlemen facilitate buying and selling while assisting in the marketing process. Transporters who assist in movement of

the produce from one market to another and communication agencies including advertising agencies which majorly help in decision making about the purchase of goods are a part of this group.

Agricultural marketing has a vital role as it helps in Optimization of Resource use and Output Management, Increase in Farm Income, Widening of Markets, Growth of Agro-based Industries, Price Signals, Adoption and Spread of New Technology, Employment Creation, Addition to National Income and Improved Living.

7.8 KEY WORDS

Gross Value Added (GVA): It is an economic productivity metric that measures the contribution of a corporate subsidiary, company, or municipality to an economy, producer, sector, or region. GVA thus adjusts gross domestic product (GDP) by the impact of subsidies and taxes (tariffs) on products.

Foreign Direct Investment (FDI): FDI is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company.

Minimum Support Price (MSP): It is an agricultural product price, set by the Government of India to purchase directly from the farmer. This is not enforceable by law. By definition, this rate is to safeguard the farmer to a minimum profit for the harvest, if the open market has lesser price than the cost incurred.

Legislative Power: It is exercised for giving exemption from licensing requirements.

Green Revolution: It is the Third Agricultural Revolution, is the set of research technology transfer initiatives occurring between 1950 and the late 1960s that increased agricultural production worldwide, beginning most markedly in the late 1960s.

Commission: Getting paid for an activity.

Liberalisation: Removal or reduction of restrictions or barriers on the free exchange of goods between nations.

7.9 SELF-ASSESSMENT QUESTIONS

1. Critically compare the pre and post 2020 Agricultural Reforms in India.
2. Give a roadmap for modifying the existing farm laws and also state their shortcomings.

3. Suggest changes in the present Agricultural Policy of India to ensure adequate growth of the country.
4. How will contract farming change the agriculture landscape in India? Discuss in detail.

7.10 REFERENCES/ FURTHER READINGS

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UNIT 8 NEW ECONOMIC POLICY

Objectives

After reading this unit you should be able to:

- understand the history of economic reforms introduced in 1991;
- discuss the meaning and measures related to Liberalisation. Privatisation and Globalisation; and
- discuss the latest economic policies of the Government like Pradhan Mantri Jan Dhan Yojana, Mudra Scheme, Swach Bharat Mission, Atmanirbhar Bharat and others.

Structure

8.1 Introduction
8.2 New Economic Policy 1991
8.3 New Economic Policy 2014
8.4 New Economic Policy 2020
8.5 Other Initiatives
8.6 Summary
8.7 Key Words
8.8 Self-Assessment Questions
8.9 References/ Further Readings

8.1 INTRODUCTION

The year 1991 is one of the landmark years in India's economic history as Economic Reforms or New Economic Policy (NEP) or policy of Liberalisation, Privatisation and Globalisation (LPG) were initiated in this year. Indian economy witnessed a paradigm shift from the policy of licence raj to liberalisation and nationalisation to privatisation.

The introduction of economic reforms was not merely a coincidence but the consequence of a multitude of problems that were brewing in the system for many years. Factors that lead to the introduction of these policy changes can be classified into two factors namely i) international, ii) domestic. International factors like the disintegration of the Union of Soviet Socialist Republics (USSR) and the Gulf wars. These factors led to a decline in Indian exports on one hand and a rise in crude oil prices along with a fall in international remittances

on the other. This was translated into the Balance of Payments (BoP) crisis, fall in foreign exchange earnings and widening of the trade deficit. Domestic factors like burgeoning fiscal deficit and inflation further fuelled the problem. The fiscal deficit reached a height of 8.4 % in 1990-91and the inflation rate was in double digits. India's foreign exchange reserves were fast depleting and they were sufficient for only three weeks of imports. India was in a precarious situation of default and debt.

To overcome these crises, India approached International Monetary Fund (IMF) for grants and assistance. IMF provided assistance with certain terms and conditions which necessitated certain changes in the economic system. Further, the policymakers also thought that it was a ripe time to learn from the growth experiences of other countries like East Asian Economies and to bring about a reorientation in the working of the economic system. This led to the introduction of economic reforms in India. These reforms have two main aspects namely macroeconomic stabilization measures and structural adjustment measures. Macroeconomic stabilization measures included tax reforms, the balance of payment reforms, monetary policy reforms and inflation control. Structural adjustment reforms included new industrial policy, banking sector reforms, phasing out subsidies, disinvestment and others. Both these policies change lead to liberalisation processes in the form of de-licencing, de-reservation and de-regulation. Increasing the role of private sectors in the functioning of the economy and disinvestment connotes privatisation. Further, changes in trade policies like reducing the rates of duties and tariffs made trade attractive, the flow of FDI and integration with world economy or globalisation. Our orientation shifted from 'Inward looking policy' to 'Outward looking policy'.

The combination of liberalisation, privatisation and globalisation ushered a new era in the economic history of India, GDP numbers increased, industrial activities gained momentum, services sector bloomed and the presence of India on the global platform was being recognised. However, the story of economic reforms is not without criticism like jobless growth, neglect of the agriculture sector and unskilled labour, the rise in income and wealth inequalities and many others.

8.2 NEW ECONOMIC POLICY 1991

Liberalisation, Privatisation and Globalisation (LPG) form the main component of New Economic Policy, 1991. In the following section, you shall read about the meaning of

liberalisation, privatisation and globalisation and the various measures undertaken to achieve the objectives of these policy measures.

Liberalisation

Liberalisation refers to curtailing or lessening of the excessive state/ government regulations and restrictions as to enhance the participation of private entities/ sectors in the functioning of the economy. Prior to the policy of LPG, the Indian economy was entangled in *Babudom*, excessive state control, red-tapism and licence raj. These factors not only inhibited the efficiency of the public sector but the overall competitiveness of the economy was hampered. Post-1991, Liberalisation measures include new industrial policy, financial sector reforms, tax reforms, FOREX reforms and others. In the Industrial policy of 1991, several measures were undertaken to liberalise the economy.

Firstly, the list of projects requiring industrial licensing was pruned and only 18 industries related to security concerns, environment, hazardous chemicals, white or luxury goods, etc were kept under the purview of compulsory licencing. **Secondly**, Industries reserved for the public sector were reduced to only two industries i.e. one related to atomic energy and second, railways. **Thirdly**, the requirement of licensing for setting up of industries within 25 Kms of the periphery of cities having a population of more than 10 lakh for a certain class of industries was removed. Fourth, to boost and invite Foreign Direct Investment (FDI) in high priority industries which requires heavy, lumpsum investment and advanced technology, it was decided to provide approval for FDI up to 51% foreign equity in 33 industries like electrical equipment, metallurgical industries, etc. Similarly, to inject technological dynamism in Indian industries, the government provided automatic approval for technology agreements related to high priority industries with specific parameters. Fifth, the Monopolies and Restrictive Trade Practices Act (MRTP) 1969 was repealed. **Sixth**, the sick industries were referred to Board for Industrial and Financial Reconstruction (BIFR) for the formulation of revival/ rehabilitation schemes.

Privatisation

Privatisation in a broader sense means a change of ownership from the public sector to the private sector and the induction of private management and control in the public sector. Three sets of measures namely i) ownership ii) organisation and iii) operational are broad measures of privatisation.

Under ownership measures, the ownership of public enterprises, fully or partially, is transferred to the private sector. Ownership measures include total denationalisation, joint venture, liquidation and worker's cooperative. Total denationalisation means 100% transfer of ownership of public enterprise to the private sector. A joint venture implies partial transfer (25%, 51% and 74%) of public enterprise to a private entity. Liquidation is the sale of assets to a person who may use them for the same purpose or some other purpose. Worker's cooperative is a special form of decentralisation whereby the ownership of the enterprise is transferred to workers who may form a cooperative to run the enterprise.

Organisational measures are imposed to limit state control. These measures include the formation of a holding company structure in which the government provided a sufficient degree of autonomy in the decision making of the company. Big companies are split into smaller units without loss of economies of scale. The smaller units become independent in certain product lines or regional operations. Leasing is another measure whereby government agrees to transfer the use of assets of a public enterprise to a private bidder for a specified period for example 5 years. The tenderers have to give an undertaking of the profit that would be passed over to the government. The government enjoys the right of obtaining profits as per agreement. In case, the bidder fails to meet the expectations of the government, the latter has the right to replace the bidder with a more promising bidder. Further, restructuring intends to bring public sector enterprise under market discipline. Restructuring is of two types namely financial and basic. Accumulated losses are written off and capital composition is rationalised in respect of debt-equity ratio in financial restructuring. In basic restructuring, the public sector shed some of its activities which are taken up by ancillaries or small scale units.

Operational measures aim to improve the overall functioning of the economy, even if fully denationalisation has not been undertaken. Operational measures include granting autonomy to public enterprises, provision of incentives to the employees, freedom to buy inputs from the market, development of proper investment criteria, permission to raise resources from capital markets for expansion or diversification.

Various measures in the Industrial policy like dereservation of industries under the public sector, increasing the limit of the FDI in industries, disinvestment policy, the opening of private sector banks, restructuring of nationalised banks are some of the steps undertaken towards privatisation. In the 1991 Budget, the government announced the intention of partial disinvestment in selected PSUs in order to raise resources, encourage wider public

participation and promote greater accountability. Up to 20 of the Government equity in 31 selected enterprises were offered to Mutual Funds, Financial Investment Institutions, workers and the general public. From 1991 to 1999 through the disinvestment method of market sale of shares Rs 18,638 crore were realised.

Globalisation

It refers to the integration of the domestic economy with the rest of the world. Globalisation connotes the reduction of the trade barriers to permit free trade, free flow of capital, technology and labour. The important measures undertaken to pursue the objectives of globalisation are:

I. **Reduction of Import Duties:** Reduction in import duties have been important measures for improvement of the tax system. During 1990, import duties were 300 % or more for several items and above 200 for many items. Peak rates were trimmed progressively during the 1990s to reach 35% in 2001-02. The median tariff rate was brought down to 25% in 2003-04. Besides reducing import duties, the government attempted to dismantle the quantitative restrictions on imports and exports. In the Import -Export policy of 1990, the list of Open General Licence (OGL) was expanded to facilitate easy access to the import of items. The number of capital goods was expanded from 1261 to 1343 under OGL. A scheme of Star Trading Houses was introduced for exporters with an average annual net foreign exchange earning of Rs. 75 crores in the preceding three licensing years.

II. **Encouragement of Foreign Investment**: As we have seen in the industrial policy of 1991, automatic approval would be given for FDI up to 51% in high priority industries. Further, in 1996, a new list of industries was approved whereby joint ventures with up to 74% foreign equity would be cleared automatically. As present in 2021, 100% FDI through automatic route is permitted in major subsectors of Mining, Broadcasting, Airports, Industrial Parks, Telecom Services, Pharmaceuticals, Single Brand Retail Trading, Textiles & Garments, Thermal Power, Tourism & Hospitality, White Label ATM Operations and Insurance & Insurance Intermediaries, etc.

Now having a glimpse about the NEP of 1991, we understand that nearly three decades have passed since the introduction of economic reforms and over time the results of these reforms have faded. So the need is felt for looking at recent policies and changes introduced in the economy and try to see how these policies and programmes are shaping the economic

landscape of the country. In the following section, we shall study the major changes and new policies which have been introduced over the past decades.

8.3 NEW ECONOMIC POLICY 2014

Foreign Trade Policy (FTP) 2015-2020

One of the important policy which affects the external sector is the foreign trade policy in India and each FTP brings new changes in the economic policy of the country. FTP is formulated every five years and currently, Foreign Trade Policy for the year 2015-2020 is in force. The major features and highlights of the FTP 2015-2020 are as follows:

Export from India Scheme

- **Merchandise Export from India Scheme (MEIS)**

Under this scheme, the scrips which will be issued will have no conditionality attached to them. The notified goods which are exported to notified markets would be rewarded on realised Free on Board (FOB) value of exports. Under this scheme, countries of exports have been grouped into three categories namely country A, B and C. Country A or traditional market includes, USA, Canada, EU and others. Country B or emerging and focus markets include Africa, Latin America and Mexico, Turkey and West Asian countries, ASEAN countries, Japan, China and others. Country C contains the list of 70 countries like Bangladesh, Bhutan, Nepal, etc. Further different types of supports like global support are extended under MEIS. Global support has been granted to fruits, flowers, vegetables, tea, coffee, spices, processed foods, marine products, handicrafts, furniture, etc. New 852 Tariff lines that fit in the product criteria but were not receiving support in earlier Foreign Trade Policy have been extended this support and these include lines from fruits, vegetables, Ayush and herbal products, paper products, etc.

Service Exports from India Scheme (SEIS)

Service exports from the India scheme have replaced the old Served From India Scheme (SFIS). This scheme aims at promoting exports of services from India, to make services more competitive in the global market and to provide incentives to exports. Under this scheme incentives ranging from 3 percent to 5 percent are provided to the exporters of services who are providing services from India to the various organisations situated outside India, The rate of incentive under SEIS is computed on the net foreign exchange earned. Business services,

communication services, construction and related engineering services, educational services, environmental, health-related services, recreational services are covered under a 5 percent rate. Services like hotels, restaurants and other services attract 3 percent rate. The rewards earned in this scheme in the form of duty credit scrips are freely transferable and can be used for all typed of goods and service tax debits on procurement of services or goods.

- The benefits of MEIS and SEIS are also extended to Special Economic Zones (SEZ).
- All duty scrips issued under MEIS and SEIS scheme and the goods imported against these scrips are fully transferable and scrips issued under Exports from India can be used for payment of customs duty, excise duty and payment of service tax.
- A new concept of Status Holders has been introduced in Foreign Trade Policy 2015-2020. Business leaders who are prominent in the arena of foreign trade and have successfully contributed to the country's foreign trade would be termed/ recognized as Status Holders. These holders would be given special treatment and privileges to facilitate their trade transactions.
- **Boost to "Make in India":** In view of encouraging domestic manufacturing and promoting brand India several measures has been introduced under FTP. Under MEIS schemes higher rewards will be provided for those export items which has high domestic content and value addition.
- Under the Export Promotion Capital Goods (EPCG) scheme, the specific export obligation has been reduced to 75 percent in case capital goods are procured from indigenous manufacturers.
- **Ease of Doing Business:** For trade facilitation and Ease of Doing Business provision for online filling of documents or applications has been made whereby various applications by exporters/importers can be filled online. Further, there is no need for hard copies of applications and specified documents. Landing documents of export consignment as proofs for the notified market can be digitally uploaded.

Goods and Service Tax (GST)

- One of the major initiatives/reforms in the Indian tax sector was the introduction of GST. GST Act was passed in 2017 by the parliament and came into effect from 1st July 2017. It is a comprehensive, multi-stage, destination-based tax that is levied on every value addition. Prior to the introduction of GST, there were a plethora of taxes levied by the Central and State Governments which lead to cascading effects of the taxes. GST has subsumed a large number of taxes and intended to simplify the structure of the indirect taxes. At present, there are four GST types namely Integrated

Goods and Service Tax (IGST), State Goods and Services Tax (SGST), Central Goods and Services Tax (CGST) and Union Territory Goods and Services Tax (UTGST).

- The major benefits accruing from GST are the creation of a unified common national market for India, giving a boost to foreign investment and the Make in India programme. Mitigation of cascading of taxes, harmonization of tax laws and procedures, simpler tax regime, increase in ease of doing business, reduction in compliance costs. For consumers, benefits are in the form of reduction of prices of goods and transparency in the fixation of final prices of the goods. More detailed information about GST is given in Unit 9.

Pradhan Mantri Jan Dhan Yojana

To widen the scope of financial inclusion in the country is the ultimate goal of inclusive growth. To bring the backward and marginalised citizens of the country under the umbrella of institutional sources of finance is the goal of the financial inclusion programme. The Government of India launched one of the biggest initiatives for financial inclusion on 15th August 2014 namely "Pradhan Mantri Jan Dhan Yojana". The mission was launched with the objective of making financial products and services approachable to the common citizens of the country at the least cost possible with the extensive use of technology to expand the coverage of financial inclusion.

The basic tenets of the scheme are to provide basic banking services to unbanked citizens in the form of opening a basic bank saving account in any bank branch or business correspondent with zero balance and zero charges. Providing debit cards with free accident insurance coverage of Rs 2 Lakh. The six main pillars of this scheme are universal access to banking services, overdraft facility of Rs.10,000 with every basic saving bank account. Expediting the programme of financial literacy in the form of spreading information about the usage of ATMs, promotions of savings, use of banking services for insurance and pension. Creation of credit guarantee fund to save the banks from defaults. To provide insurance cover with both accident insurance upto Rs 1,00,000 ((enhanced to Rs. 2 lakh to new PMJDY accounts opened after 28.8.2018) and life insurance of Rs 30,000 and to provide a safety net to the workers working in the unorganised sector through a pension scheme.

PMJDY account can be used for Direct Benefit Transfers (DBT) for the social security schemes namely Pradhan Mantri Mudra Yojana (PMMY), Atal Pension Yojana (APY), Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY) and Pradhan Mantri Suraksha Bima Yojana (PMSBY). Post-2018, the focus of PMJDY has shifted from " Every Household" to "Every Unbanked Adult". The overdraft facility has increased to Rs 10,000 from Rs 5000 and the age limit for the overdraft facility has been increased to 65 years. As of April 2021, the total number of PMJDY account stood 42.25 Crore and in these accounts, Rs 145408.07 crore was deposited and 30.93 crore Rupay cards were issued. Further, Jan Dhan Darshak App was also launched to provide necessary information related to banking services like locating ATMs, Bank Branches etc.

Mudra Scheme for MSME

To revitalise and meet the credit need of non-corporate, non-farm micro and small enterprises Prime Minister Mudra Yojana (PMMY) was launched in 2015. These micro-enterprises plays an important role in labour surplus country like India. These enterprises are labour intensive, need less credit, caters to local economy needs and plays a supplementary role to the medium and large Industries. However, they reel under the problem of deficiency of finance and depend upon non-institutional sources of finance like money lenders. So to expand the ambit of the institutional sources of finance to this sector PMMY was launched. MUDRA stands for Micro Units Development and Refinance Agency and provided loans upto Rs 10 Lakhs to eligible enterprises.

MUDRA is a wholly-owned subsidiary of Small Industries Development Bank of India (SIDBI) with an authorised capital of Rs 1000 crores and 750 crores of paid-up capital. Micro enterprises can borrow term loans or overdraft facility without any need for collateral, processing fee and this scheme does not prescribe any minimum amount of loan, small to small loans can be taken. MUDRA schemes have three categories namely Sishu, Kishor and Tarun.

Under the Sishu scheme, a maximum loan of Rs 50000 is sanctioned for start-up micro-enterprises. Kishor categories cater to the need of entrepreneurs who are looking for a fresh fund for the expansion of business and they can avail of the loan ranging between Rs 500001-Rs 5 Lakh. If the entrepreneurs are looking for diversification of their operation then they avail the loan facility in the Kishor category. Under this category, the loan amount is sanctioned Rs 5,00,000 to Rs 10,00,000. Entrepreneurs can take a loan for the commercial

vehicle, plant and machinery, business loans and working capital. In the financial year 2020-21, Rs. 43370003 PMMY loans were sanctioned.

Swachh Bharat Mission (SBM)

On 2nd October 2014, Prime Minister Sh. Narendra Modi launched a multi-pronged programme to augment the sanitation drive in the country namely Swachh Bharat Mission (SBM) or Clean India. This programme was launched at the backdrop that in 2014 more than half of the population (55 crore people) practised open defecation. The situation was not only grim in a country like India alone nearly 2.3 billion people globally lacked basic sanitation services. Under SBM, beneficiaries were provided with an incentive of Rs 12000 for the construction of Individual household latrines. The financial burden was shared in the 60:40 ratio between the central government and state government. However, in the case of special categories states (like J&K, HP, North Eastern states) this participatory role increased to 90:10. Further, permission was also granted to create avenues for additional contributions from other sources also. SBM is not about providing financial incentives also rather it is about capacity building and aims at instilling behavioural change among communities and individuals. Since its inception, the percentage of fund utilization under this scheme has been more than 95 percent. Nearly 10 crore toilets have been built since 2014 and 711 districts declared as free from open defecation.

Make in India

With the idea and desire of transforming India into a global design and manufacturing hub and to boost domestic manufacturing PM in September 2014 launched a much-hyped initiative of 'Make in India'. The intuition was to create a conducive environment that encourages investment not only domestic but foreign also and built a network of modern and efficient infrastructure. This programme has three objectives. First, to boost the manufacturing sector and increase the growth rate of this sector to 12-14 percent per annum. Second, to make the manufacturing sector one of the largest employment provider sectors and to create 100 million additional manufacturing jobs by 2022. Third, to increase the share of manufacturing upto 25 percent by 2025. This scheme focuses on 25 sectors namely automobiles, aviation, chemicals, construction, defence manufacturing, electronic system, food processing, leather, mining, pharma, railways, tourism, renewable energy, etc.

Major Initiatives under Make in India

- Ministry of defence reserved 26 items that will be only procured from local suppliers.
- NLC India announced to set up a 500 MW Solar Power Plant in Odisha with the cost of Rs 3,000 crore.
- FDI in the defence sector increased to 74 percent under the automatic route.
- 100 percent FDI under automatic route for construction and specified rail infrastructure projects.

Stand Up India

To promote entrepreneurial skills among women and to bring the marginalised section of the society i.e Schedule Caste (SC) and Scheduled Tribe (ST) individuals into the net of financial inclusion a scheme called Stan-Up India for financing SC/ST and/or Women Entrepreneurs was launched in 2016. Under this scheme, a composite bank loan of Rs 10 lakh and Rs 100 lakh (1 crore) is provided for setting up greenfield enterprises to be advanced to at least one SC/ST borrower and at at least one women borrower per bank branch. The enterprise may be in the manufacturing, services, trading sector or activities allied to agriculture like pisciculture, beekeeping, poultry, etc. To provide collateral-free coverage, GoI has set up the Credit Guarantee Fund for Stand-Up India (CGFSI). The loan needs to paid back in 7 years with 18 months of the maximum moratorium period. Nearly Rs 26000 crore has been sanctioned till 2021.

PM Ujjwala Yojana

To provide clean and efficient Liquified Petroleum Gas (LPG) to rural India, PM Modi launched PM Ujjwala Yojana in 2016. This scheme aimed at providing 5 crore LPG connections to women below the poverty line across India. The scheme provides financial support of Rs 1600 for each LPG connection which includes cylinder, stove, pressure regulator and the financial burden is borne by the government.

Skill India

Skill India or Pradhan Mantri Kaushal Vikas Yojana (PMKVY) is the flagship scheme of the Ministry of Skill Development and Entrepreneurship (MSDE). This scheme was launched in 2015 with the target of providing industry-relevant skill training and financial and placement assistance to over 10 million youth between 2016-2020. MSDE has et up different agencies

and institutions to focus on different areas and activities. Three agencies are playing a prominent role in achieving the target of PMKVY, namely, National Skill Development Authority (NSDA), National Skill Development Corporation (NSDC) and Directorate General of Training (DGT). NSDA is tasked with the implementation of the National Skills Qualification Framework (NSQF) and strengthen State Skill Development Missions (SSDMs). NSDC is entrusted with the implementation of PMKVY and Pradhan Mantri Kaushal Vikas Kendra (PMKK) while DGT is tasked with the establishment and monitoring of Industrial Training Institutes (ITIs).

Activity 1

1. Visit the website of Pradhan Mantri Jan Dhan Yojana and check the progress of this scheme in your state and district.

2. Visit the website of Make in India and choose any one sector of your choice like agriculture, health, digital awareness and list out the changes or reforms introduced in this sector under the ambit of the make in India scheme.

8.4 NEW ECONOMIC POLICY 2020

Atmanirbhar Bharat

COVID pandemic had a devastating effect on all the economies of the world be it either big or small, developed or underdeveloped. It had a deep impact on the economic growth and the income and employment nosedived. It made the policymakers rethink the way the economic

system works. It was at this juncture that Prime Minister of India, Sh Narender Modi while announcing an economic package related to pandemic echoed the slogan of Atmanirbhar Bharat in May 2020. This was followed by a clamour that whether India is regressing towards an old socialist pattern of a closed economy and we are going to fly against the wind of globalisation. Though the different versions of Atmanirbhar Bharat were already part and parcel of the Indian planning process since 1976. And even some mention can be found in the Tenth Five-Year plan also. In 2020, Atmanirbhar Bharat was declared as Oxford Hindi word of the year.

This should not be only understood as self-reliant only as it is frowned upon by global economics. It connotes policies that aim towards promoting resilience, efficiency and equity. PM again in 2021, emphasised that the core of this slogan is about the creations of values, wealth and ethos not only for India but for the larger humanity. Till now three packages has been given under this scheme (Appendix-I).

The main constituents of Atmanirbhar Bharat are:

I. Demand
II. Demography
III. Economy
IV. Infrastructure
V. System

The Government of India via this package has tried to extend a helping hand to almost every sector of the economy i.e. Micro, Small and Medium Enterprises (MSMEs), farmers, rural labourers, migrants or the empowerment of the poor. We will discuss some of the financial and policy highlights which were initiated under the various economic packages given under this scheme.

Micro, Small and Medium Enterprises (MSMEs)

- **Revision of Definition**: One of the prominent reforms in this sector was to redefine MSMEs and this done through amending the MSMEs Development Act, 2006. Earlier there was a different definition of the enterprises in the manufacturing sector and enterprises engaged in the service sector. But now this distinction is abolished and one common definition in terms of investment in plant and machinery and annual turnover. The new definition is given below.

The new definition of MSMEs			
	Micro	Small	Medium
Investment in plant and machinery	Not more than Rs 1 crore	Not more than Rs 10 crore	Not more than Rs 50 crore
Annual Turnover	Not more than Rs 5 crore	Not more than Rs 50 crore	Not more than Rs 250 crore

- Collateral free loan of upto three lakh crore rupees to MSMEs which aims to provide benefit to nearly 45 Lakh units.
- Rs 10,000 crore fund created to help these enterprises.
- To expand the government procurement from MSMS it was decided not to float global tenders of up to Rs 200 crore in various procurement undertaken by the government.
- A subordinate debt of Rs 20,000 crore for equity support for the stressed MSMEs.

The Agriculture and Allied sectors

The following are some of the measures undertaken to strengthen agriculture and allied sectors.

- To develop infrastructure in the agriculture sector a corpus amounting to One lakh crore to be set up at aggregation points and farm-gate. Farmgate is the place where both farmers and buyers can interact directly with one another.
- For crop loan requirements an additional fund of Rs 30,000 crore is allocated and it will be disbursed via the National Bank of Agriculture and Rural Development (NABARD) to Rural Cooperative Banks and Regional Rural Banks (RRBs).
- To support the fishermen and fisheries Pradhan Mantri Matsya Sampada Yojana (PMMSY) was launched. Under this scheme total of Rs 20,000 crores has been allotted for, Aquaculture inland fisheries and marine along with the development of Infrastructures like cold chains and fishing harbours.
- To help the dairy industry an Animal Husbandry Infrastructure Development Fund of Rs 15000 crore was set up.
- To control the foot and mouth disease and Brucellosis a National Animal Disease Control programme was launched with an outlay of Rs 13,343 crore for achieving universal vaccination of cattle, buffalo, goat, pigs and sheep.

- Rs 500 crore has been extended for beekeeping initiatives.
- The government has decided to amend The Essential Commodities Act, 1955 to deregulate food items like edible oil, onions, pulses, potatoes and oilseeds to attract investment in the sector.

Migrant Workers

- **One Nation One Card** scheme had been launched whereby migrants can access the Public Distribution System (PDS) from anywhere.
- 5 Kg of grain per person and 1 kg of chana per family per month for two months will be given to all those migrant workers who are not beneficiaries under the National Food Security Act ration card or state card. It is estimated it will benefit eight crore migrants.
- Pradhan Mantri Awas Yojana envisages providing living facilities at an affordable price to migrant labourers/urban poor.
- Rs 5000 crore credit facility to street vendors which are the most affected segment of the population due to ongoing pandemic. Under this facility, the bank credit facility for initial working capital upto Rs 10,000 for each enterprise will be extended.

Civil Aviation and Defence

- Airports with world-class infrastructure to be built through Public-Private Partnership (PPP). The Airport Authority of India has initially awarded three airports of Ahmedabad, Lucknow and Mangaluru for operation and maintenance on a PPP basis.
- Foreign Direct Investment (FDI) limit in defence manufacturing increased to 74 % from 49 % under automatic route.
- Reservation for Indian vendors in some categories like production agency in Design and Development, etc and further FDI of more than 40 percent is not allowed.
- The Ministry of defence will bring out the list of items on which the ban of the import of certain items shall be announced.
- Mission Raksha Gyan Shakti launched to promote innovation and technology development.

Energy

- To improve the functioning and efficiency of the power sector it was decided to privatise power department/utilities in Union Territories.

- To ensure a progressive reduction in cross-subsidies in the sector it was decided to amend the Electricity Act, 2003.
- Rs 118,273 crore worth of loans have been sanctioned to 17 states/UTs for liquidity injection for DISCOMs.

Social Sector

- MGNREGS has been given an additional allocation of Rs 40,000 crore to provide impetus to rural demand and employment.
- To further strengthen and enhance technology in the education sector PM eVidya will be launched for digital/online education.

8.5 OTHER INITIATIVES

Other measures / initiatives include the following:

- Festival advance scheme to government employees under SBI Utsav cards.
- New Leave Travel Concession (LTC) voucher scheme launched.
- A new scheme Atmanirbhar Bharat Rozgar Yojana launched to create new job avenues during the COVID recovery phase.
- Rs 1.46 lakh crore boost has been given to 10 champion sectors like advanced, electronic /technology products, pharmaceutical drugs, cell chemistry battery, telecom and networking products, food products, high-efficiency solar PV modules, automobiles and auto components, White goods and speciality steel, textile products.
- Rs 18,000 crore additional outlay for PM Awaas Yojana-Urban.
- Rs 900 crore provided for Covid Suraksha Mission for R&D of Indian Covid vaccine.

Further, under this slogan, various sub slogans like Vocal For Local, Local for Global, etc were echoed.

National Food Security Mission

This mission was launched in 2007 as a centrally sponsored scheme which aimed to increases the annual production of rice, wheat and pluses by 10 million tonnes, 8 million tonnes and 2 million tonnes respectively by the end of 2011-12. This increase in production was intended to achieve by restoring soil fertility, improving farm level economy, expanding the area under cultivation and fostering new employment avenues. Subsequently, from 2014-15, coarse

cereals and commercial crops like sugarcane, cotton and jute were also included under this mission. Further, it was decided to extend this mission to 2019-2020 and new targets of achieving production of 13 million tonnes of additional foodgrain production are fixed. At present this mission is being implemented in selected districts of 29 states of the country.

National Food Security Act (NFSA) 2013

A paradigm shift in the country food security occurred in 2013 when the government enacted NFSA, 2013 which made provision to distribute subsidized foodgrains under the Targeted Public Distribution System (TPDS) to nearly 75 % of the rural population and 50 % of the urban population. Under this act, identified households are provided 5 Kg foodgrains per person at the highly subsidised price of Rs 3 for rice, Rs 2 for wheat and Rs 1 for coarse grains. Households covered under Antyodaya Anna Yojana (AAY) to receive 35 kg per family per month. This act also includes Mid Day Meal (MDM) and Integrated Child Development Services (ICDS). Pregnant women and lactating mothers and children in the age group of 6 months to 14 years are entitled to nutritious meals. Maternity benefits of not less than Rs 6,000 are given to pregnant women and lactating mothers. The ration cards are in the name of the eldest woman of the household of age 18 years or above. This act also provides for a grievance redressal mechanism at the district and state levels apart from social audits to ensure transparency and accountability. If the states are not able to supply the entitled foodgrains to the beneficiaries the act makes the provision for food security allowance. At present this act is being implemented in all States/UTs, covering nearly 80.5 crore persons.

Smart Cities Mission

Smart Cities Mission was launched in 2015 for rejuvenating urban development. It aims to enhance economic growth along with improving the quality of life of people living in cities through comprehensive work on physical, economic, social and institutional pillars of the city. The focus is on inclusive and sustainable development. To promotes and provide the core infrastructure like adequate water supply, sanitation, assured electricity supply, solid waste management, affordable housing, digitalization, e-governance, sustainable environment, the safety of women, children and elderly, health and education. 100 cities were to be selected based on two-step criteria. This is a centrally sponsored scheme and at the time of inception, Rs 48,000 crore were sanctioned over five years. Smart Command and Control

Centres has been completed in 16 cities. Smart water, Smart Roads, Smart Solars have been completed in 24 cities, 23 cities and 15 cities respectively.

Bharat Net or National Optical Fibre Network (NOFN)

In the mission of connecting rural India with internet services, National Optical Fibre Network was launched in 2011 and was renamed Bharat Net in 2015. This mission envisages connecting all 2,50,000 Gram panchayats with the minimum 100 Mbps bandwidth covering nearly 625,000 villages. Bharat Broadband Network Limited (BBNL) is the special purpose vehicle created as Public Sector Undertaking (PSU) for the execution of NOFN. The project aims to provide e-services and e-applications like e-health, e-education, etc.

Activity 2

1. Choose one of the cities from your state that is covered under the Smart Cities mission and prepare a note about the various facilities, financial resources, etc which are granted to your city. Try to analyse whether the city has turned smart or not?

8.6 SUMMARY

In this unit, we started with the history of economic reforms and the rationale behind introducing the same in the country. The year of 1991 is remembered as a year of economic reforms wherein NEP was introduced which liberalised India from the clutches of licence raj, excessive government controls, permit raj, red-tapism and state-created monopolies. India adopted a positive outlook for globalisation and policies were initiated to integrate the Indian economy with the rest of the world. However, more than 30 years have passed since this policy so the need was felt to look into recent changes in the economic field. More specifically to look into some of the economic changes which were undertaken in the last decade or so.

To provide basic financial and insurance services to the financially excluded section of the society and to curb the ongoing leakages in various welfare schemes. The trinity of JAM was introduced and Jan Dhan Yojana is one of the steps in this right direction.

Similarly, the Mudra scheme is intended to benefit budding entrepreneurs and MSMEs. Following the proverb of cleanliness is next to godliness, Swachh Bharat Mission was initiated to clean the neighbourhoods and prevents the spread of infectious disease along with improving the living conditions of the citizens. Finally, to strengthen domestic manufacturing and improve the process of industrialisation the ambitious project of Atmanirbhar Bharat is being implemented. This scheme is impacting every sector of the economy and one of the visible impacts in the recent pandemic is the manufacturing of homemade vaccine Covaxin.

8.7 KEY WORDS

Cess: It is a tax on tax. It is levied by the government for a specific purpose like health, education etc.

Financial Inclusion: Initiative by the government to bring the financially excluded sections like marginalised sections, women, tribals, etc under the umbrella of formal credit facilities.

Fiscal deficit: It is the difference between the total income of the government i.e. total tax receipts and non-debt capital receipts and total expenditure.

Foreign Direct Investment: It is an investment made by a firm or individual in one country but its headquarter/control is in another country.

PDS: Public Distribution System is a system of providing subsidised ration including foodgrains, edible oil, sugar, pulses etc to the targeted proportion of the population.

Tax: Tax is a compulsory payment made by individuals or corporations to the Government

Trade deficit: It is a situation wherein the country's imports and higher than exports.

8.8 SELF-ASSESSMENT QUESTIONS

1. Discuss the rationale behind economic reforms introduced in India in 1991.
2. What are the eligibility conditions and benefits received by PMJDY beneficiaries?

3. What are the facilities offered under Swach Bharat Mission to individuals?
4. Discuss between financial and basic restructuring.

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a. **Appendix-I**

Atmanirbhar Bharat Abhiyan

The Hon'ble Prime Minister, Shri. Narendra Modi announced a special economic package on 12 May 2020 of Rs.20 lakh crore (equivalent to 10% of India's GDP) under the 'Atmanirbhar Bharat Abhiyan'. This special economic package was announced to make India independent against the tough global supply chain competition and help empower the labourers, poor and migrants who had been severely affected by the COVID-19 pandemic.

Accordingly, the Finance Minister, Smt. Nirmala Sitharaman announced the details of the measures provided under the Atmanirbhar Bharat Abhiyan through five press conferences. These measures are provided to different sectors and areas to cover and help everyone affected by the pandemic. The measures were announced keeping in mind the five pillars of Atmanirbhar Bharat Abhiyan. These five pillars are the pillars for making India self-reliant.

Five Pillars of Atmanirbhar Bharat Abhiyan

The five pillars of Atmanirbhar Bharat Abhiyan are:

- **Economy** – That brings quantum jump rather than incremental change.
- **Infrastructure** – To become the identity of modern India.
- **System** – That is driven by technology and a system not based on the past policy.
- **Demography** – India's strength is its demography, and it is the source of energy for self-reliant India.
- **Demand** – The demand and supply chain in the economy is the strength that must be harnessed to its rightful potential.

Measures Provided Under Atmanirbhar Bharat Abhiyan

The various measures are undertaken by the government under the Atmanirbhar Bharat Abhiyan in different sectors are as follows:

Reforms for MSME

- The Emergency Credit Line Guarantee Scheme (ECLGS) to Businesses or MSMEs from Banks and Non-Banking Financial Companies (NBFCs) up to 20% of the entire outstanding credit as of 29.2.2020.
- Rs.20,000 crore for Subordinate Debt for Stressed MSMEs.
- Rs.50,000 crore equity infusion for MSMEs through 'Fund of Funds', which are doing viable business but need hand holding due to the pandemic situation.
- Revision of MSME definition by increasing the upper limits of turnover and investments in plant machinery and equipment for MSME. The new definition differentiates MSME under the criteria of investment and annual turnover, which is the same for both the manufacturing and service sector.
- For protecting MSMEs from foreign company competition, global tenders of up to Rs.200 crore will be disallowed in government procurement tenders.

Reforms for Agriculture, Fisheries and Food Processing Sectors

- Rs.1 lakh crore for Agri Infrastructure Fund to farmers for farm-gate infrastructure.
- Rs.10,000 crore scheme for Formalisation of Micro Food Enterprises (MFE).
- Rs.20,000 crore for fishermen through Pradhan Mantri Matsya Sampada Yojana (PMMSY).
- Animal Husbandry Infrastructure Development Fund set up for Rs.15,000 crore to support private investment in Dairy Processing, cattle feed infrastructure and value addition.
- Promotion of Herbal Cultivation with an outlay of Rs.4,000 crore.

Reforms for Employment and Ease of Doing Business

- Additional allotment of Rs.40,000 crore for MGNREGS for boosting employment.
- Decriminalisation of the Companies Act, 2013 for ease of doing business.
- Permission for direct listing of securities by Indian public companies in foreign jurisdictions.
- Private companies that list Non-convertible debentures (NCDs) on stock exchanges will not be regarded as listed companies.
- Including the provisions of Producer Companies (Part IXA) of Companies Act, 1956 in Companies Act, 2013.
- Power to the National Company Law Appellate Tribunal (NCLAT) for creating additional or specialised benches.
- Lowering of penalties for all defaults for One-person Companies, Small Companies, Producer Companies and Startups.

Reforms for Poor, Farmers and Migrant Workers

- Introduction of One Nation One Card. The migrant workers can access the Public Distribution System, i.e. Ration from the Fair Price Shop situated anywhere in India under the scheme of One Nation One Card.
- Provided living facilities to the migrant labours and urban poor at affordable rent under the PMAY (Pradhan Mantri Awas Yojana).
- PM Svanidhi scheme launched to facilitate easy access to credit for urban street vendors.
- NABARD extended Rs.30,000 crore additional re-finance support for meeting crop loan requirements of Regional Rural Banks and Rural Cooperative Banks.
- A special drive to give concessional credit to PM-KISAN beneficiaries through the Kisan Credit Cards. Animal Husbandry Farmers and Fishermen are also included in this drive.

Atmanirbhar Bharat Abhiyan 2.0

After the announcement of Atmanirbhar Bharat Abhiyan by the Prime Minister on 12 May 2020, announcements were made on 12 October 2020 under Atmanirbhar Bharat Abhiyan 2.0. Under Atmanirbhar Bharat Abhiyan 2.0:

- SBI Utsav Cards were distributed.
- 11 States were sanctioned Rs.3,621 crore towards the capital expenditure as an interest-free loan.
- LTC voucher schemes were launched.
- Additional capital expenditure of Rs.25,000 crore was provided to the Ministry of Road Transport and the Ministry of Defence.

Atmanirbhar Bharat Abhiyan 3.0

On 12 November 2020, the Finance Minister, Smt. Nirmala Sitharaman, along with the Minister of State for Finance and Corporate Affairs, Shri. Anurag Thakur launched the Atmanirbhar Bharat 3.0 for boosting the Covid-hit economy.

Twelve announcements were made by Finance Minister Nirmala under the Atmanirbhar Bharat 3.0, which focused on job creation and tax relief in the housing sector. The twelve announcements are as follows:

- Launch of Atmanirbhar Bharat Rozgar Yojana for the creation of new employment opportunities.
- Launch of ECLGS 2.0 for supporting stressed sectors with a tenure of 5 years, including a moratorium of 1 year.
- Rs.1.46 lakh crore for Atmanirbhar Manufacturing Production Linked Incentives (PLI) for 10 champion sectors.
- An additional outlay of Rs.18,000 crore provided for the PMAY-Urban.
- The performance security on contracts was reduced to 3% instead of 5-10% to ongoing contracts free of disputes and Public Sector Enterprises to support infrastructure and construction.
- Demand booster for the Residential Real Estate Income Tax relief for the Home Buyers and Developers from 10% to 20% (under section 43CA) for only primary sale of residential units valuing up to Rs.2 crore.
- Rs.6,000 crore Equity infusion in NIIF Debt Platform and Rs.1.10 lakh crore Platform for Infra Debt Financing.
- Rs.65,000 crore for subsidised fertilisers for helping 140 million farmers.
- An additional outlay of Rs.10,000 crore provided for Pradhan Mantri Garib Kalyan Rozgar Yojana.
- Rs.3,000 crore released to EXIM Bank for promoting the export projects through lines of credit under the IDEAS scheme.

- An additional outlay of Rs.10,200 crore towards Capital and Industrial expenditure.
- Rs.900 crore provided for the COVID Suraksha Mission for Research and Development of Indian COVID-19 Vaccine to the Department of Biotechnology.

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UNIT 9 FINANCIAL SECTOR AND FISCAL SECTOR REFORMS

Objectives

After reading this unit you should be able to:

- review the major reforms introduced in the financial and fiscal sector during and after 1991;
- discuss reforms in the banking and insurance sector; and
- discuss tax reforms introduced in India in recent times.

Structure

9.1 Introduction
9.2 Banking Sector Reforms 1991
9.3 Reforms in Financial Sector
9.4 Reforms in the Insurance Sector
9.5 Tax Reforms 1991
9.6 Fiscal Sector Reforms
9.7 Summary
9.8 Key Words
9.9 Self-Assessment Questions
9.10 References/ Further Readings

9.1 INTRODUCTION

In Unit -5 you have studied the circular flow of income, output and employment and learnt how various sectors of the economy interact with one another. In circular flow, the financial sector plays a pivotal role in channelising savings and investment. The banking and insurance sector is an important constituent of the financial sector. You must have noted that even after so many decades of India's Independence large chunk of the population is not covered by formal banking and insurance services. Due to the dearth of these services, the social security of the citizens is threatened and they have to be dependent on non-institutional sources of credit/finance which is exploitative. The financial sector is itself marred with problems like Non-Performing Assets (NPA), inefficiencies, lack of capital and many more. In this unit we will examine the major banking sector reforms introduced as part of New Economic Policy

(NEP) 1991 and then move to recent reforms introduced in the financial sector especially post 2010.

Fiscal policy is related to taxation, expenditure and public debt. Tax is mainly of two types direct and indirect. An efficient tax system is necessary for collecting tax revenue in the country. In unit 8, you have learnt about economic reforms of 1991 and during the process of liberalisation, privatisation and globalisation a series of measures were introduced in the fiscal sector in form of direct and indirect tax reforms.

In recent years, the economic policies of the country have taken a new direction and dimension whereby emphasis is placed on domestic manufacturing, bringing more investment both from the private and foreign sectors, reducing foreign dependence. Make in India and Ease of Doing Business are the buzz word. To achieve these objectives lot of reforms have been introduced in the banking sector, insurance sector, labour market, direct and indirect taxes and similarly in many other sectors. In this unit, you will study major reforms and policies undertaken in these sectors.

9.2 BANKING SECTOR REFORMS 1991

In continuation to NEP and to bring structural reforms in the working of the economy, a series of measures were introduced in the financial sector especially in the banking sector. In the following section, you will study about these reforms. In 1991, the Government of India set up the Narasimham Committee to examine all aspects relating to the structure, functioning, organization and procedure of the financial system to remodel these institutions for raising the overall efficiency.

Narasimham Committee, 1991

Narasimham Committee was set up in 1991 to analyse the falling efficiency of the India banking sector and then recommended certain reforms to revive the banking sector.

Major recommendations of the Narasimham Committee, 1991 are:

I. The committee felt that the present structure was too rigid and inflexible so it proposed the deregulation of the interest rate structure and said that the interest rate should be determined by market forces.

II. Re-examination of direct credit programme and to include small and marginal farmers, tiny industrial sector and weaker sections. The aggregate credit to the redefined priority sector to be fixed at 10%.

III. Reduction of Statutory liquidity ratio (SLR) to 25% over a period of 5 years from 38.5% in 1991. Further, the cash reserve ratio (CRR) to be reduced in a phased manner from the existing rate of 15%.

IV. Establishment of 4 tier hierarchy for the banking structure which should be as follows:

a) 3-4 banks (including SBI) at the top of the banking structure and they could become international in character.
b) 8-10 banks engaged in general or universal banking and they would have a network of branches throughout the country.
c) Local banks whose operation would be confined to a specific region.
d) Regional banks including Reginal Rural Banks (RRBs) would be confined to rural areas and they would be engaged in financing agriculture and allied activities.

V. Introduction of prudential norms and regulation:

a) **Definition of Non-Performing Assets:** An asset would be considered non-performing if the interest on such assets remains past due for a period exceeding 180 days at the balance sheet date. Banks and financial institutions to be given a period of 3 years to move towards these norms.
b) For the purpose of provisioning, the committee recommended classifying assets into 4 categories, namely, standard, sub-standard, doubtful and loss assets. Regarding the substandard, a general provision should be created equal to 10 percent of the total outstanding under this category. In case of doubtful assets provision should be created to the extent of 100 percent of security shortfall. In respect of the secured portion of some doubtful debts, further provision should be created ranging from 20 percent, 50 percent depending on the period for which such assets remain in the doubtful category. With respect to loss assets, it is suggested that either fully they be written off or provision be created to the extent of 100 percent. The committee also

suggested that a period of 4 years should be given to the banks and financial institutions to conform to those provision requirements.

c) Banks and financial institutions should achieve a minimum of 4 % capital adequacy ratio by March 1993 of which Tier-1 capital should not be less than 2%.

VI. An Asset Reconstruction Fund (ARF) to be established for the recovery of loans. This fund would take a portion of the bad and doubtful debts of the banks at a discount.

VII. End to the duality of control and RBI should be the primary agency for the regulation of the banking system.

VIII. To provide autonomy to the banks the chief executive of the bank should be appointed based on professionalism and integrity and not on political consideration.

IX. Banks can access the capital market and issue of fresh capital to the public through the capital market.The Banking Companies (Acquisition and Transfer of Undertaking) Act was amended so that banks can raise capital through public issues but to the condition that the holding of Central Government would not fall below 51% of paid-up capital.

X. Setting up of new private sector banks if they conform to the requirement of minimum start-up capital and other requirements. Further, there should not be any differential treatment between public and private sector banks.

XI. Opening of foreign banks to open offices in India either as branches or as subsidiaries.

Narasimham Committee II -1998

This committee was given the mandate to review the progress of banking sector reforms, and design a programme to further strengthen the financial structure, technological up-gradation, human resource development, capital adequacy norms and bank mergers. The major recommendations include:

I. A stronger banking system in the context of Current Account Convertibility (CAC). Indian banks must be made capable of handling problems pertaining to domestic liquidity and exchange rate management. So strong banks need to be merged which will have a multiplier effect on the industry.

II. Revival of Narrow Banking Concept whereby weak banks should place their funds only in short term and risk-free assets like government securities.

III. Setting up of small, local banks which would cater to needs of states or cluster of the district to serve local trade, small industry and agriculture.

IV. Banks should aim to reduce gross NPAs to 3 % by 2002.

V. To improve the strength of the Indian banking system the government should raise capital adequacy norms of 9 % by 2000, 10 % by 2002.

VI. Banks to give more autonomy and freedom in the recruitment of skilled, specialized manpower from the market.

VII. Rapid introduction of computerization and technology.

VIII. Amendments in the Banking Regulation Act, Nationalisation Act and State Bank of India Act, RBI Act, Bank Nationalisation Act, etc. to allow greater autonomy, higher private-sector shareholdings, and so on.

9.3 REFORMS IN FINANCIAL SECTOR

The Government of India from time to time have been making certain reforms to strengthen and stabilize the financial sector.

I. Financial Stability and Development Council (FSDC)

The government of India, in 2010 created an apex body (non-statutory) to promote financial sector development and strengthen the mechanism for maintaining financial stability. The regulator is entrusted with the responsibility to maintain macro-prudential supervision in the country, inter-regulatory coordination and financial development issues. The Union Finance Minister is the chairperson of the FSDC and other members include the governor of RBI, chairman of SEBI, IRDA and others.

II. Merger of Forward Markets Commission (FMC) with the Securities and Exchange Board of India (SEBI)

As you must be familiar with forward trading in the context of shares in which buyers and sellers agree to trade a financial asset at a future date at a specified price. Similarly, forward contracts are agreements in the commodity market concerning the future delivery of a commodity at the pre-negotiated prices. The Forward Market Commission (FMC) established in 1953 acted as the regulatory body for the commodity futures market in India.

However, as part of Financial Sectors Reforms, FMC was merged with the Securities and Exchange Board of India (SEBI) in 2015. The merger aimed at realising the benefits of economies of scope and scale for exchange and to harmonize the regulation of commodity derivatives and the securities market.

III. Insolvency and Bankruptcy Code, 2016

Before the Insolvency and Bankruptcy Code, 2016, there were several laws and procedures mostly overlapping and adjudicating forums that dealt with insolvency and financial failure of individuals and companies in India. The institutional and legal framework imposed a heavy strain on the Indian credit system as there was no time limit on the effective and time recovery or restructuring of defaulted assets. Reforms in the bankruptcy and insolvency regime were critical not only for credit markets which were under a lot of stress but for the ease of doing business in the country. The new code aims at consolidating and amending laws relating to reorganization and resolution of corporate persons, individuals and partnership firms in a time-bound manner i.e. 180 days in case of companies. However, a subsequent amendment in this code in 2019 (The Insolvency and Bankruptcy Code (Amendment) Act, 2019) has enhanced the mandatory upper time limit to 330 days which includes time spent in the various legal processes to complete the resolution process.

To promote entrepreneurship and availability of credit and balance the interests of all the stakeholders, under the new Code, the National Company Law Tribunal (NCLT) will now adjudicate insolvency resolution for companies and the Debt Recovery Tribunal (DRT) will adjudicate insolvency resolution for individuals. Establishment of the Insolvency and Bankruptcy Board of India will oversee the insolvency proceedings in the country and regulation of all entities registered under it.

To speed up the implementation of this Code, Government of India established the Tribunals, National Company Law Tribunal (NCLT) and National Company Appellate Tribunal (NCLAT) and Insolvency and Bankruptcy Board of India (IBBI) in 2016.

Box 9.1: Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021

The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021 was promulgated in 2021. The Ordinance targeted the corporate persons classified as MSMEs to provide them with an efficient alternative insolvency resolution framework and to provide cost effective, faster and value maximising outcomes for all the stakeholders . This is to be done in such a manner which is least disruptive and preserve jobs. The incorporation of Pre-packed insolvency resolution process for MSMEs in the code is expected to provide some reflief to Covid hit sector. The timely and cost effective resolution of distress can ensure positiveness to debt market, employment preservation and ease of doing business.

Source: The Insolvency and Bankruptcy Code (Amendment) Ordinanace, 2021.

IV. Banking Regulation (Amendment) Ordinance, 2017

One of the biggest problems in the Indian banking system pertains to Non-Performing Assets (NPA). Over the years they have accumulated and have reached trillion of crore rupees. To deal with the problem of stressed assets, Banking Regulation (Amendment) Ordinance, 2017 was promulgated in 2017. The bill has amended the Banking Regulation Act, 1949 and has inserted two new sections namely 35AA and 35AB after Section 35A. Accordingly, RBI is now authorized to direct banking companies to resolve specific stressed assets by initiating an insolvency resolution process wherever required. The RBI is also empowered to issue other directions for the resolution of the stressed assets. RBI can also form committees to advise banks on the resolution of stressed assets and the members of such committees will be appointed by the RBI. The Ordinance enabled RBI to deal with NPAs quickly. Accordingly, now the Oversight Committee can bypass three major factors/hurdles which slowed the resolution process. These are: 1) stop 'free riding' by lenders who did not participate in the resolution process. 2) compliance after an agreement has been sealed. 3) certify the process to alleviate fears of future investigations.

V. The Banking Regulation (Amendment) Act, 2020

To find a solution to the deteriorating condition of cooperative banks in the country, the government amended the Banking Regulation Act, 1949 and promulgated Banking Regulation Amendment Bill, 2020. The major objective is to bring cooperative banks under the supervision of the RBI.

RBI, after placing the bank under a moratorium can prepare a scheme for reconstruction or amalgamation of the bank. This is done once the RBI is satisfied that such an order is necessary to protect the interest of the depositors, public of the banking system. However, the act also allows RBI to initiate such a scheme without imposing a moratorium.

The Cooperative bank can now issue equity shares, preference shares or special shares to its members or to any other person residing within its area of operation, They can also issue unsecured debentures or bonds with a maturity of 10 years or more to such person with the prior approval of RBI. No person can demand payment towards the surrender of shares that are issued by a cooperative bank.

The RBI may exempt a cooperative bank or a class of cooperative banks from a certain provision of the Act through notification. The cooperative banks cannot employ someone who is insolvent or has been convicted of a crime. The RBI has the power to remove the chairman if he/she is not fit for the position and can appoint another person as chairman.

Cooperative banks cannot make loans or advances on the security of their own shares. They cannot grant unsecured loans or advances to their directors or to private companies where the bank's director or chairman is an interested party. The Act has specified certain conditions under which unsecured loans or advances may be granted and it specifies how these loans may be reported to RBI.

The cooperative banks without prior approval of RBI, cannot open a new place of business or change their location outside the city, town or village in which it is currently located. This Act does not apply to Primary Agricultural Credit Societies (PACS) and cooperative land mortgage banks.

9.4 Reforms in the Insurance Sector

To provide a universal social security system especially to the underprivileged and the poor population of the country, the three major schemes were launched in 2015 namely, Pradhan Mantri Suraksha Bima Yojana, Atal Pension Yojana and Pradhan Mantri Jeevan Jyoti Bima Yojana. We shall study some details about these schemes in the following sections.

I. Pradhan Mantri Suraksha Bima Yojana (PMSBY)

The scheme provides for coverage of Rs 2 Lakh for accidental death and permanent total disability and Rs 1 lakh for partial disability. This renewal of one-year accidental-death-cum-

disability cover is available to account holders in the age group of 18-70 years. The premium of Rs 12 per annum is deducted from the bank account through the 'auto debit' facility in one instalment. As of April 2021, cumulative gross enrollment by banks in PMSBY stood at 23.36 crores. Over 45,600 claims were disbursed under this scheme.

II. Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)

This scheme offers a renewable one-year term life cover of Rs 2 lakh to all subscribing bank account holders. The subscribers can be in the age group of 18-50 years.. PMJJBY is offered by Life Insurance Corporation (LIC) and all other life insurers. A premium of Rs 330 per annum is auto-debited in one instalment from the subscriber's bank account.As of April 2021, cumulative gross enrollment by banks in PMJJBY stood at 10.32 crores. Over 2,39,000 claims were disbursed under this scheme.

III. Atal Pension Yojana (APY)

In 2015, the Government introduced Atal Pension Yojana (APY) to provide pension especially to people engaged in the unorganised sector like gardeners, maids, etc,. APY replaces the previous Swavalamban Yojana. This scheme provides a defined pension depending upon the contribution and its period. The subscribers are subject to the minimum pension of Rs 1000, 2000, 3000, 4000 or 5000 per month, from the age of 60 years contingent upon the contribution by the subscribers and the age at the time of joining the scheme. The spouse of the contributor in the case of death and nominee in case of death of both the contributor and spouse can claim pension /paid the accumulated corpus. The central government co-contributes 50% of the total contribution subject to a maximum of Rs 1000 per annum, to each subscriber's account, for a period of five years, i.e. from FY 2015-16 to 2019-20. To avail the benefit of this scheme the subscriber should not be part of other social security schemes like EPF or be paying income taxes. As of April 2021, a total number of 304.33 lakh people have enrolled, under APY.

IV. Ayushman Bharat

This Scheme was launched on the recommendation of the National Health Policy, 2017 to achieve the Universal Health Coverage (UHC). Ayushman Bharat scheme is launched to meet Sustainable Development Goals (SDGs) and its commitment of "Leave no one behind". This scheme has two inter-related components namely Health and Wellness Centres (HWCs) and Pradhan Mantri Jan Arogya Yojana (PM-JAY).

Health and Wellness Centres (HWCs): These centres were developed to cater to the primary health care need of the citizens in their respective areas. A large number of services related to reproductive, maternal, newborn, communicable diseases, ENT, Ophthalmology and others are to be provided in these centres, so that people need not run to nearby towns or cities ultimately leading to saving of both time, energy and money.

Pradhan Mantri Jan Arogya Yojana (PM-JAY): It was launched in 2018 in Jharkhand by Hon'ble PM. It is the largest public health insurance scheme in the world aiming to provide Swasthya Suraksha to nearly 10.74 crore poor and vulnerable families as per the Socio-Economic Caste Census, 2011 and the beneficiaries of Rashtriya Swasthya Bima Yojana. The Scheme provides a cover of Rs 5 Lakh per family per year for medical and hospitalization expenses in most of the secondary and tertiary hospitals. 3 days of pre-hospitalisation and 15 days post-hospitalization expenses are covered under this and all pre-existing diseases are covered from day one onwards. In 2020, according to National Health Authority, cashless treatments of nearly Rs 15,500 crore was provided under Ayushman Bharat PMJAY.

Activity 1

1. Choose any bank of your preference (public, private or foreign) and from its website look into its growth over a period of time like branch expansion, credit-deposit ratio, etc. Also, look for data on the NPA of that bank.

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9.5 TAX REFORMS 1991

The government of India has appointed many committees to suggest measures in both the direct and indirect taxation system of the country.

Chelliah Committee 1991

To examine the structure of both direct and indirect taxes, a Tax Reform Committee under the chairmanship of Dr Raja J. Chelliah was constituted in 1991. The main task of the committee was to give suggestions on ways to improve the elasticity of direct and indirect taxes, making the taxation system broad-based and fair. Rationalisation of the direct taxes and improving

equity, to identify new areas for taxation and methods of improving tax compliance and strengthening enforcement. The committee made the following recommendations and most of these suggestions were incorporated in the budget of 1993-94 (Appendix -I).

Kelkar Committee

In 2002, a task force under the chairmanship of Dr Vijay Kelkar was constituted to recommend measures for simplification and rationalisation of direct and indirect taxes. The committee recommended formulating a simple, effective and better tax system. For direct tax, the recommendations were related to raising the exemption limit of personal income tax, abolition of wealth tax, long term capital gain tax, etc. Further, widening of the tax base, expansion in the coverage of service tax, etc. were the recommendations for indirect taxes (Appendix-II).

Kelkar Committee on Fiscal Consolidation

In August 2012 a Committee was constituted under the chairmanship of Dr. Vijay Kelkar to outline a roadmap for fiscal consolidation. The main reason behind constituting the Committee was that in 2012-13, the fiscal deficit was soaring high and it was estimated to reach 6.1% of GDP and a higher fiscal deficit is a cause of worry for the economy which could lead to higher inflation, the external balance could widen, investment, growth and employment tend to weaken and the overall confidence of investor is shaken. The recommendations of the Committee are given in (Appendix- III).

Direct Tax Reforms

Direct Taxes are those taxes in which the impact and incidence of the tax fall on the same person. Examples like Income Tax, Corporation Tax, etc. A series of reforms have been introduced in the direct taxes which are given in (Appendix-IV).

Changes in Direct and Indirect Tax in Union Budget 2021-22

In Union budget 2021-22, the Finance minister has proposed the major changes/reforms in the direct and indirect taxes (Appendix-V).

9.6 FISCAL SECTOR REFORMS

Goods and Service Tax (GST)

In India, the constitution of India gives the power both to the state and central government to levy taxes. Central government levies tax like custom duty, central sales tax, etc. and state government levies taxes like Value Added Tax (VAT). There was a large number of multiple taxes at various levels of the supply chain levied by both Centre and State government that lead to a complex structure of the indirect taxes. The cascading of taxes which is due to the 'tax on tax' ultimately inflate the price of the goods and services artificially and the ultimate burden of these indirect taxes fall on consumers. This set of multiple taxes with different tax bases and tax rates are also costly to administer and comply with. So it was decided to have one comprehensive indirect tax or consumption base tax namely Goods and Service Tax (GST). The concept of GST was introduced in the year 2000. A task force on Fiscal Responsibility and Budget Management was formed in 2003 and it recommended the introduction of GST in 2004. However, it came into effect by 101st Amendment to the Constitution of India from 1st July 2017. The motto of GST is *'One Tax, One Market and One Nation'*. With the implementation of GST large number of indirect taxes were subsumed into it. GST replaced the taxes levied and collected by the Centre namely service tax, central excise duty, duties of excise on medicinal and toilet preparations, additional duties of Excise (Goods of special importance and textiles and textile products), additional duties of customs, special additional duty of customs and cesses and surcharges related to supply of goods and services. State taxes like state value-added tax (vat), central states tax, purchase tax, luxury tax, entry tax, taxes on advertisements, entertainment tax and amusement tax (except those levied by the local bodies), state cesses and surcharges on supply of goods and services.

Salient Features of GST

GST is applicable on 'supply of goods' or services as against manufacture of goods or on sale of goods or provision of services. It is a destination-based consumption tax. It is a dual GST namely Central GST (CGST) and State GST(SGST). CGST is levied by Centre Government and SGST is levied by State Government. An Integrated GST or IGST is levied on the inter-state supply of goods or services. IGST is levied and collected by Centre Government and is divided among the Union and the States on the recommendation of the GST Council. At present there are 4 rates of GST namely 5%, 12%, 18% and 28%. Some of the items which are

exempted from GST are alcohol for human consumption. Similarly, petrol, high-speed diesel, supply of petroleum crude, natural gas and aviation turbine fuel and electricity are kept outside GST.

GST Council

GST council act has a provision for the GST council which is an apex committee on GST matters. The composition of the members includes the chairman of the council (which is the Union Finance Minister), The Union minister of state in charge of revenue or finance, one member from each state who is the minister in charge of finance or taxation or any other member. The Vice-chairman is elected among these members of the state. The secretary of the revenue department is the Ex-Officio secretary and the chairperson of the Central Board of Excise and Customs is the permanent invitee in the GST but has no voting right. GST council recommends the Union Government of India and States on subsuming various taxes, cess and surcharges in GST. Deciding on the threshold limit below which services and goods will be exempted from GST. Details of services and goods that will be subjected to GST or will be exempted. Making special provisions to special category states namely Jammu and Kashmir, Himachal Pradesh, Arunachal Pradesh, Assam, Mizoram, Nagaland, Manipur, Meghalaya, Sikkim, Tripura, and Uttarakhand. Model IGST laws, principles of levy, apportionment of IGST and the principles that govern the place of supply. Any special rate of rates for a specified period to raise additional resources during a disaster or natural calamity and any other matter relating to GST.

Input Tax Credit

Input tax credit refers to the tax which was already paid by the seller/manufacturer at the time of purchase of goods or service and which is available as a deduction from the tax payable or the seller can reduce/deduct the tax which they already paid on inputs at the time of paying tax on output. For example, seller A bought the goods of amount Rs 18,000 and these goods attract GST @ 18% so the GST amount is Rs 3240. Now, seller, A sold these goods for Rs 22,000 and this attracts GST @18% or Rs 3960. In this case, the net GST payable will be (Rs 3960 -Rs 3240 = Rs 720) and the input tax credit is Rs 3240.

GST Network (GSTN)

GSTN is a non-profit, non-government organisation and manages the entire information and technology system of the GST portal. Taxpayers file their tax returns through this portal and the government can track every financial transaction through GSTN.

Advantages of GST

Some of the benefits which can accrue due to GST are the creation of a unified common national market for India and boosting the "Make in India" campaign.

- Elimination of multiple taxes and mitigating the cascading of taxes, harmonization of laws and rates of taxes.
- Evolution of simple tax regime, increase in ease of doing business, reduction in the prices of goods in the long run thus benefit to customers.
- According to Economic Survey 2020-21, the Government received GST revenue worth Rs 1.15 lakh crore in December 2020 along with the ongoing pandemic of COVID-19.

Activity 2

Study the latest budget and economic survey and read about any new changes introduced in fiscal measures like change in income tax rate or new changes in direct or indirect taxes and list them.

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9.7 SUMMARY

In this unit, we studied the financial and fiscal sector reforms which were introduced as part of NEP. Within the financial sector, banking sector reforms initiated on the recommendation of the Narasimham committee were of much importance. These reforms overhauled the financial sector in general and the banking sector in particular. Post-1991 reform period, recent reforms in the banking and insurance sector have focused on expediting the insolvency resolution process and a maximum time limit has been imposed to finalise these processes. RBI can now have more supervision on the functioning of cooperative banks. The cooperative banks can now float shares and debentures and work more efficiently. Schemes like PMSBY, PMJJBY and APY seek to cover the unbanked proportion of the population and aims to bring them under the ambit of formal basic banking and insurance services. These schemes aim at extending the net of social security to the vulnerable workers and sections of society along with the provision of health facility in the nearby Primary Health Centres.

The taxation reforms 1991 attempted to make taxation broad-based and increasing the compliance mechanism. Recently the introduction of GST attempted to overhaul the existing indirect tax regime in the country which was plagued with multiple taxes and that lead to an artificial increase in the prices. GST has opened up entire India as a single market with easing the movement of goods across states. Since its introduction, this system has shown many encouraging results in the form of an increase in tax collection and revenue.

9.8 KEY WORDS

Insolvency: It is the state in which a person or company is unable to pay the debt at maturity.

Fiscal Year: It is one year period that is used for financial reporting and budgeting by companies and governments.

Non-Performing Assets (NPAs): It is a loan or advance that are in default or arrears. The principal or interest payment is due for 90 days.

Incidence of Tax: It is the final burden of the tax. Incidence is one person who ultimately bears the real burden of the tax.

Direct Tax: Taxes which are imposed on individuals or corporation. The impact and incidence of these taxes are on the same persons. Income tax, corporation tax, wealth tax, are some of the examples.

Indirect Tax: It a tax in which impact and incidence are on different entities. These taxes can be passed on to another individual. They are generally imposed on manufacturer or suppliers who ultimately pass on the burden to the final consumer. Some of the examples of indirect tax are GST, VAT, customs duty, etc.

9.9 SELF- ASSESSMENT QUESTIONS

1. Discuss the major advantages and features of GST.
2. What are the major facilities offered under the Ayushman Bharat Scheme?
3. Discuss the Service exports from the India Scheme under Foreign Trade Policy 2015-2020.
4. Critically examine the recommendations of the Narasimham Committee.
5. Critically examine the recommendations of the Kelkar Committee.

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Appendix-I

i) Reduction in rate of corporate tax from 51.75 % to 45 % and further reduction to 40 % from 1994-95.

ii) Abolition of surcharge on corporate tax.

iii) Abolition of Interest tax

iv) To continue gift tax (however, exemption limit ehnaced to Rs 30,000 from 20,000)

v) Tax on agricultural income of non-farmers if it exceeds Rs 25,000.

vi) To extend Value Added Tax (VAT) tax system upto the manufacturing level.

vii) To start TIN (Taxpayer Identification Number) in place of Permanent Account Number (PAN) for the identification of taxpayers.

viii) To reduce the import duty ceiling to 50 % from the existing 110 %.

ix) To minimise the tax slabs.

x) Import duty to have five slabs, lowest 5 % and highest 30 %.

xi) 50 % import duty on non-essential consumer items.

xii) Duty-free import of wheat and rice, but oilseeds, pulses and other agricultural products to have 10 % ad valorem import duty.

xiii) Duty-free imported items should be charged 5 % duty under the 'Protection' head.

xiv) 5 % import duty on inputs of fertiliser and newsprints production.

xv) 20 % import duty on medical equipment

xvi) To continue the advanced licencing system for exporters.

Appendix-II

Tax Administration

I. To expand taxpayer services both quantitatively and qualitatively.

II. Extension of PAN to cover all economic agents/citizens.

III. The time limit of 4 months for the processing of tax returns and refunds.

IV. Transparency and objectivity in the process of selection of cases.

V. Establishment of a Tax Information Network on a build, operate and transfer basis to speed up the process of modernisation and consequent simplification and rationalisation of the scheme of tax deduction at source.

VI. Enhancing the accountability of officers and staff.

VII. To provide more administrative and financial powers to the Central Board of Direct Taxes (CBDT).

Direct Tax

i) Generalised exemption limit raised to Rs 1 lakh from Rs 50,000.

ii) Exemption limit of Rs 1,50,000 for widows and senior citizens

iii) 3 tier income tax structure replaced with 2 tier structure.

Taxable Income	tax rate(%)
Upto 1 lakh	nil
1-4 lakh	10
Above 4 lakh	20

iv) Standard deduction and surcharge abolished.

v) Tax incentives for saving needs to be withdrawn.

vi) To encourage investment in an annuity-oriented pension scheme proposal to double the exemption under 80 C to Rs 2 Lakh from 1 lakh.

vii) Deduction under Section 80CCC for contribution to pension funds to be increased from Rs.10,000 to Rs.20,000

viii) Abolition of dividend and long term capital gain tax.

ix) Tax rebate on housing interest reduced to Rs 50,000 from Rs 1.5 lakh and 2 % interest subsidy on housing loans upto 5 lakh.

x) Income tax on agriculture income should be left to states.

xi) Tax rebate schemes under section 88, 88 B and 88 C withdrawn.

xii) The deduction for handicapped under 80 DD and 80 U to continue.

xiii) 5 % surcharge on income tax to be withdrawn.

xiv) For domestic companies, corporate tax reduced to 30 % from 36.75 %.

xv) For foreign companies, tax on income reduced to 35 % from 40 %.

xvi) No tax on the distribution of dividends by a company.

xvii) The general rate of depreciation for plants and machinery reduced to 15 %.

xviii) Minimum alternative tax under section 1157 B abolished.

xix) Elimination of tax incentives under Section 88, 80L and interest income under section 10.

Indirect Taxes

i) The multiplicity of levies to be reduced to three, viz., basic customs duty, additional duty of customs and anti-dumping duties

ii) For raw materials, inputs and intermediate goods customs duty reduced to 10 % and for consumer durables it was reduced to 20 % by 2004-05.

iii) Removal of exemption under Section 33AB, 33AC, 33B, 35, 35AC, 35CCA .

iv) By 2006-07, customs duty for coal, ores and other raw materials to be reduced to 5 % and for capital goods, basic chemicals to 8 %.

v) Higher duty of 150 % for specified agri-products and demerits goods.

vi) Complete exemption of customs duty on life-saving drugs and defence-related equipment.

vii) Central excise duty on kerosene raised by Rs 1 per litre.

viii) Duty exemption for Small Scale Industries (SSIs) with turnover upto Rs 50 lakh.

ix) By 2003, the nationwide introduction of VAT and service tax.

x) Removal of exemption under Section 33AB, 33AC, 33B, 35, 35AC, 35CCA etc.

xi) Income of mutual funds derived from short-term capital gains and interest to be taxed at a flat rate in the hands of the mutual funds.

xii) The merger of tax on expenditure in hotels with service tax.

xiii) A duty of 8 percent on crude oil and 15 percent on petroleum products from 2003-04. A duty of 5 percent on crude oil and 10 percent on petroleum products from 2004-05.

xiv) All levies to be reviewed and to be replaced by only one levy, i.e., the CENVAT.

xv) A uniform rate of 16 percent on all fibres and yarns, by raising duty on cotton yarn from 8 percent to 14 percent and bringing down duty on polyester filament yarn to 14 percent in four instalments.

xvi) All exemptions to be removed on the textile sector except for fabrics woven handlooms, handloom fabric certified as khadi, etc.

Appendix- III

I. To bring the tax to GDP ratio to the high levels of 2007-08 i.e. 11.9 %

II. Establishment of data warehousing and data mining infrastructure, modernise outdated investigation processes.

III. Revision of Direct Taxes code bill.

IV. Implementation of GST.

V. Revision of the negative list of services that are exempted from tax.

VI. Proposal of 'call option model' to accelerate the disinvestment process.

VII. Establishment of Exchange Traded Fund to provide investors with the benefits of diversification, low-cost access and flexibility.

VIII. Selling of minority holdings in largely private entities.

IX. To mitigate the financial burden of subsidies, the committee suggested increasing the price of diesel by Rs 4/liter, Rs 2/litre in kerosene and Rs 50 per LPG cylinder. The committee also recommends phasing out the subsidy on diesel and LPG by 2014-15.

X. Increase the price of urea by 10 %.

Appendix- IV

- The Taxation Laws (Amendment) Ordinance,2019 provides a concessional tax regime of 22 % for all domestic companies from the Fiscal Year 2019-2010 provided they do not avail any exemption/incentive. If surcharges and cess is also included then the effective tax rate is 25.17 %. Such companies have been given exemption from paying Minimum Alternate Tax (MAT).
- To give a boost to the '*Make in India*' initiative a new provision is introduced in Income Tax Act, which allows that any new domestic company to pay income tax at a 15 % tax rate if it is incorporated on or after 1st October 2019. Such companies should not avail any exemption/incentive and commence production on or before 31st March 2023. Further, these companies are given exemption from paying Minimum Alternate Tax (MAT).
- The rate of MAT has been reduced to 15 % from 18.5 %.
- In accordance with the Finance Act, 2019, exemption of income tax to individuals earning income up to Rs 5 Lakh and the standard deduction is increased from Rs.40,000 to Rs. 50,000.
- The Finance Act, 2020, provides an option of paying income tax at concessional rates to individuals and corporation, if they do not avail exemption/incentive.
- Dividend Distribution Tax (DDT) stands abolished.
- Direct Tax Vivad se Vishwas Scheme, 2020 to reduce the litigations and settle the cases which are long pending before various appellate forums.
- **Faceless E-assessment Scheme and Faceless Appeals:** To eliminate the interface between the assessing officer and the assesses and optimising the use of resources these schemes/option was launched.
- **Unique Document Number:** To bring efficiency and transparency to every communication.
- Encouragement to digital transactions to reduce unaccounted transactions.
- Provision of hassle-free tax environment to Startups like simplification of the assessment procedure, exemption from Angel-tax, etc.
- A transaction like huge cash withdrawal, purchase of a luxury car, sale of goods, etc. would be under the ambit of Tax Deduction at Source (TDS) and Tax Collection at Source (TCS). These steps are undertaken to widen the tax base and ultimate increase in tax revenue.

Appendix-V

Changes in Direct and Indirect Tax in Union Budget 2021-22

Direct Taxes

I. No change in the income tax rates for individuals and corporations

Income range	tax rate
Upto 2,50,000	Nil
2.5 lakh to 5 lakh	5
5 lakh to 10 lakh	20
Above 10 lakh	30

II. Faceless Assessment and Faceless Appeal introduced.

III. Senior citizens over 75 years of age having only pension and interest income exempted from filing tax returns.

IV. The time limit for reopening of cases reduced to 3 years from 6 years.

V. Dispute resolution committee to be set up for taxpayers with taxable income upto Rs 50 lakh and disputed income upto Rs 10 lakh.

VI. Rules to be notified for NRIs regarding their foreign retirement accounts.

VII. For entities that carry out 95 % transaction digitally the limit for such entities for tax audit increased to Rs. 10 crore from the existing Rs. 5 crore.

VIII. Dividend payment to REIT/ InvIT exempt from TDS.

IX. Infrastructure Debt Funds cab raise funds by issuing Zero Coupons Bonds.

X. Additional deduction of interest, up to Rs. 1.5 lakh, for the loan taken to buy an affordable house extended for loans taken till March 2022.

XI. Tax holiday for Affordable Housing projects extended till March 2022.

XII. Tax exemption allowed for notified Affordable Rental Housing Projects.

XIII. Tax holiday for capital gains from incomes of aircraft leasing companies.

XIV. Tax exemptions for aircraft lease rentals paid to foreign lessors.

XV. Tax incentive for relocating foreign funds in the IFSC.

XVI. Tax exemption to investment division of foreign banks located in IFSC.

XVII. Capital gains exemption for investment in start-ups extended till 31st March, 2022.

Indirect Taxes

I. Major measures were undertaken under GST. Nil return through SMS, Quarterly return and monthly payment for small taxpayers, Electronic invoice system, Validated input tax statement, Pre-filled editable GST return, Staggering of returns filing, Enhancement of capacity of GSTN system, Use of deep analytics and AI to identify tax evaders.

II. Revised, distortion-free customs duty structure to be put in place from 1st October 2021 by reviewing more than 400 old exemptions.

III. New customs duty exemptions to have validity up to the 31st March following two years from its issue date.

IV. Customs duty reduced uniformly to 7.5% on semis, flat, and long products of non-alloy, alloy, and stainless steels.

V. Duty on steel scrap exempted up to 31st March 2022.

VI. Anti-Dumping Duty (ADD) and Counter-Veiling Duty (CVD) revoked on certain steel products.

VII. Duty on copper scrap reduced from 5% to 2.5%.

VIII. Duty on solar invertors raised from 5% to 20%, and on solar lanterns from 5% to 15% to encourage domestic production.

IX. Exemption on import of duty-free items rationalized to incentivize exporters of garments, leather, and handicraft items.

X. Exemption on imports of certain kind of leathers withdrawn.

XI. Customs duty on cotton increased from nil to 10% and on raw silk and silk yarn from 10% to 15%.

XII. Agriculture Infrastructure and Development Cess (AIDC) on a small number of items.

UNIT 10 INTERNATIONAL FINANCIAL SYSTEM

Objectives

After reading this unit you should be able to:

- explain how the international financial system works;
- identify the institutions responsible to stabilise and reconstruct the countries in need of such assistance;
- describe the roles and functions of Bretton Woods Institutions; and
- distinguish between International Monetary Fund (IMF) and World Bank.

Structure

10.1 Introduction

10.2 International Monetary Fund (IMF)

10.3 The World Bank

10.4 World Bank Group Institutions

10.5 Difference between IMF and the World Bank

10.6 International Monetary System

10.7 Summary

10.8 Key Words

10.9 Self-Assessment Questions

10.10 References/ Further Readings

10.1 INTRODUCTION

The international financial system is an arrangement through which the financial flows are governed. This is a combination of financial systems of individual countries and monetary arrangements (like European Monetary Union), the operation of organisations like the World Bank and the IMF, exchange rate systems followed by individual countries and the role of

USA as an anchor country. The present-day financial architecture of the world is complex given the level of global integration achieved between countries. Hence, policies of individual countries can cause problems for their trade partners. The major role of the international financial system is to maintain stability. Countries may run into difficulty due to paucity of foreign exchange and default on their payment obligations. This may affect the lenders and cause a ripple effect throughout the globe. Hence a mechanism needs to be put in place to prevent such fluctuations through a system of providing the finances with the conditionality that appropriate policies would be perused to correct the imbalances.

The two World Wars caused a lot of disruptions and one of the major impacts was on the countries severely damaged by them. These countries had to depend on countries like USA for funds to reconstruct their economies. USA did help those countries but need was felt for institutions which could supplement this and take the responsibility for problems which could be faced in the future. In 1944 the Bretton Woods Conference agreed to form the World Bank and IMF. Political conflicts led to economic conflicts during and after the wars. Protectionism led to reduction in World trade and also caused a slowdown of the world GDP. Exchange rates were floated or being pegged at will causing a lot of disruptions. Hence a need was felt for a coordinated arrangement where the member countries can only deviate when they faced a "fundamental disequilibrium". Though the IMF has not given any definition of what they mean by "fundamental disequilibrium" it can be construed as a situation where the outward payments continuously deviate from inward payments.

To understand the international financial system thus we need to start from the Institutions entrusted with task of maintaining its stability. The IMF and the World Bank will be discussed in the next two sections.

10.2 INTERNATIONAL MONETARY FUND (IMF)

The IMF is an autonomous international organisation of around 190 countries. Members subscribe to its quota and in turn IMF provides assistance during the crisis of balance of payments (BoP). Further, technical assistance to help countries better manage their economy and training and policy advice is also part of IMF's responsibilities. The IMF came into existence on December 27, 1945 after the articles of agreement was adopted by the members during the Bretton Woods Conference in 1944. The mandate of IMF according to the articles of agreement establishing it are as follows:

- To promote cooperation among the members in monetary matters and provide a forum for discussions to maintain cordial relationships;
- To smoothen the process so that international trade is fostered, employment levels increase, real incomes grow and productive resources accumulate for the member countries;
- To incentivise orderly exchange rate arrangements and its stability and see to it that the members don't indulge in competitive devaluation;
- To help the member countries develop a system of payments to facilitate multilateral transactions and to remove restrictions on foreign exchange which hampers trade;
- To become a vehicle through which members can get over difficult times in terms of payments problems by accessing its resources so that they don't have to resort to policies which are further damaging; and
- To lessen the trauma of the member countries by shortening the time and degree of disequilibrium in BoP.

Functions

The IMF performs the following functions which range from surveillance of member countries to advisory for mobilising of external finance.

1. IMF has the mandate and legal backing to monitor the economies of the member countries to check whether they conform to its objectives.
2. Major function of IMF is direct lending to member countries to get over temporary BoP difficulties and to see to it that they take corrective measures so that the disequilibrium adjusts smoothly.
3. Low-income countries are helped by IMF through linking them to external donor agencies and sources of funds. Along with World Bank, IMF helps such countries in their payments and development spheres. IMF is also involved with debt relief and high indebtedness of these countries.
4. IMF's constant monitoring of the members' economic wellbeing helps donors and financial markets to properly gauge the economies. This helps them get external funding.
5. The institution also serves as a forum for consultations and international coordination among member countries to prevent disorderly movements in exchange rates.

6. Supply additional international liquidity through issuing of Special Drawing Rights (SDRs) if need is felt. SDRs are the unit of account in which the Fund transacts with its members but they are not a claim on the institution. SDRs can be exchanged for convertible currencies.
7. IMF also engages in training and capacity building of especially developing country members in areas of its expertise. This helps the members to avoid costly mistakes while formulating economic policies.
8. In order to serve its members in a better way the Fund undertakes research in areas where it normally advices. The research is disseminated through Reports, Working Papers, Journal articles through electronic modes. It is also a major source of cross-country data on financial, monetary and economic variables useful to its member governments, researchers and business people.

IMF's Policies over the Years

IMF's bailout role starts with the country in crisis approaching it. Mostly this happens when the countries are on the verge of defaulting on external obligations like imports or external debt servicing. IMF decides on the modalities of help which majorly are soft loans proportional to the country's quota. The repayment schedule is decided on the basis of the liquidity condition of the country so that they don't face any problems. In lieu of the help the countries need to follow IMF conditionalities. Such conditionalities are mainly targeted towards bringing the country back to the growth path. Typically, they are policies to improve budgets, reduce inflation, privatisation, liberalisation which are basically market-oriented policies. IMF cannot force the countries to follow the conditionalities but can withhold further assistance or delay subsequent sanction of loans. One of the major criticisms against such policies has been that it ignored the ground realities in the crisis-hit countries. In many cases including some countries in Latin America and Africa, such policies led to reduction in GDP growth due to inability of such countries to compete with now liberal imports. Further, the austerity measures to curtail government expenditure to improve budgets along with increased taxes added to the problems of recipient countries. A one-size-fit-all strategy was criticised by many experts.

Many commentators claim that IMF policies not only caused economic malaise but led to major health disasters like Ebola outbreak in Africa where debt repayment was emphasised over resulting lack of resources to fight such a health disaster. Most often the recipient

countries refused to follow the prescribed policies leading IMF to threaten to cut them off from future aid. However, studies found that conditionalities had little impact on effectiveness of IMF programmes. From a structuralist point of view when one looks at IMF's dealings with recipient countries interesting facts emerge. Countries close to US are less stringently dealt with. Countries receiving debt from other international organisations get preferential treatments while disbursing loans. Countries favourably looked at by UN agencies are especially the temporary members of Security Council. In many cases the conditionalities were more severe in case of the highly affected country. Even when well meant conditionalities sometimes led to adverse international reserve position and higher interest rates for the recipient countries. Many feel it is not the problem with conditionality alone but lack of mechanisms to properly enforce them was also a problem area. IMF rarely succeeded in punishing the countries for not following its dictates. The change in IMF's assistance programme has been dramatic in case of geographic coverage. For the first time IMF was involved in bailing out European countries following the Sovereign Debt Crisis. The major initiative was in Greece where the bailout was to the tune of $375 billion over eight years. The amount was larger than the normal proportion of bailout (relative to membership subscription).

The jury on IMF's effectiveness is still tilted towards negative. Some experts argue that to be fair no one knows without these policies what would have happened. Role of IMF's policies in helping East Asian countries to quickly recover from the crisis in 1997-98 was lauded. Further, the assistance provided to Brazil in 2002 was another IMF success story where the country could repay the debt before scheduled date. But austerity programmes in Greece and Spain have led to 30% youth unemployment. Some cite Ireland as a success story for the bailout programmes.

IMF have added more strategies like 'flexible credit line' and a 'precautionary and liquidity line' to help countries in difficulties but who otherwise don't qualify for assistance. Further, in order to tackle the criticisms levelled by developing countries IMF have been proactive in helping them in achieving the Millennium Development Goals (MDGs). In view of some of the troubled countries seeking relief from other countries and not IMF, the Fund has tried to improve on transparency and timeliness of the assistance. On leadership part though it has still a lot to achieve as the MD has most of the times been from some European country and the other members especially developing countries are bitter about it.

During the recent Covid Crisis IMF doubled the funds available for assistance through Rapid Financing Instrument and Rapid Credit Facility. A demand of almost $100 billion was construed. More than 100 countries have asked for relief. Till August, 2020 almost 70 countries have been touched through $30 billion loans. Chile and Peru have been given assistance through Flexible credit line. Poorest countries have been given grants to cover their payments in the interim period. The Fund has also requested wealthy countries including China to resist from asking the poorest countries to pay their debt obligations in this difficult year. Thus, the Fund has come a long way from stringent conditionalities to a more flexible approach. Further, now it is trying to cater to the development needs of the poorest countries.

Activity 1

1. Find out from internet or other sources at least two countries which have got assistance from IMF.

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2. Did policies suggested by IMF benefit these countries? Write detailed note.

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10.3 THE WORLD BANK

This institution also came into being after the Bretton Woods Conference. The major role perceived for the institution was to re-build the countries severely impacted by World War II. It functions like a development financial institution and an investment bank at the same time. After its operations in the war-ravaged countries their conditions improved. The Bank then

shifted focus to the development needs of the poor countries. The funding source for the Bank's operation is mainly capital markets. Issuing bonds and grants received from its members are its other sources of funding. Direct selling of bonds and notes to its member countries are also sometimes resorted to raise funds.

Roles of World Bank

- **Assist countries to come out of indebtedness**: Due to the two oil price shocks in 1980s many developing countries were on the brink. The Bank resorted to adjustment lending to restore economic growth in such countries. Later focus shifted to poverty reduction and re-tuning the adjustment lending to achieve this objective.

- **Poverty reduction**: This has become a thrust area for the Bank and has led to major loans to poverty afflicted countries over the years. The areas through which this was done is mentioned in the following box.

Box 10.1: Thrust Areas

Agricultural and Rural Development, Aids, Anti-Corruption, Debt Relief: Heavily Indebted Poor Countries, Education and Training, Energy, Environment, Evaluation Monitoring, Financial Sector, Gender, Globalization, Global Monitoring, Governance and Public Sector Reform, Health, Nutrition and Population, Information and Communication Technologies, Infrastructure, Knowledge Sharing, Law and Justice, Macroeconomics and Growth, Mining, Participation, Policies, Poverty, Private Sector Development, Social Development, Social Protection and Labour, Sustainable Development, Trade, Transport, Urban Development.

Source: World Bank Website

- **Country Assistance**: The mandate of the Bank was to lend to clearly identified projects for intervention. It was soon realised that the countries targeted were not capable of identifying projects. Thus, the Bank had to involve itself into policy reviews, advising on policy making, formulating projects to ask for assistance etc. The country assistance has the following steps as mentioned in the box below.

Box 10.2: Stages of Assistance

1. Country Assistance Strategy

The Bank prepares lending and advisory services, based on the selectivity framework and areas of comparative advantage, targeted to country poverty reduction efforts.

2. Identification

Projects are identified that support strategies and that are financially, economically, socially, and environmentally sound. Development Strategies are analyzed.

3. Preparation

The Bank provides policy and project advice along with financial assistance. Clients conduct studies and prepare final project documentation.

4. Appraisal

The Bank assesses the economic, technical, institutional, financial, environmental, and social aspects of the project. The project appraisal document and draft legal documents are prepared.

5. Negotiations and Board Approval

The Bank and borrower agree on loan or credit agreement and the project is presented to the Board for approval.

6. Implementation and Supervision

The borrower implements the project. The Bank ensures that the loan proceeds are used for the loan purposes with due regard for economy, efficiency, and effectiveness.

7. Implementation and Completion

The Implementation Completion Report is prepared to evaluate the performance of both the Bank and the borrower.

8. Evaluation

The Bank's independent Operations Evaluation Department prepares an audit report and evaluates the project. Analysis is used for future projects.

Source : World Bank Website

- **Provider of International Public Goods**: The Bank is looked upon to provide necessary advice regarding economic policy and risks involved in general in investing in certain countries. The public goods provided by the Bank are strengthening the democratic processes, promoting partnership with the private sector, providing knowledge about and relevant to development, global environment, correcting market failures, rectification of information failures, elimination of drug trafficking, management of global capital flows along with overcoming market imperfections and policy intervention in poor countries.

- **Knowledge Bank**: Given its expertise in a wide-ranging area the Bank is a repository of information which spans across countries and sectors. The Bank needs research to decide its intervention strategy and to monitor the countries to identify early warning signs. Based on research the Bank can provide relevant advice to its member countries. The databases hosted by the Bank can be used by academicians, policy makers, corporate, etc. for their relevant work. Doing Business Reports, World Integrated Trade Solutions are some of the very useful Reports and databases used widely across the world.

Activity 2

1. Search for World Bank projects especially in the area of infrastructure in India. What are the features of the projects and what is the role of World Bank in facilitating such projects?

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2. In the area of poverty-alleviation what is the World Bank projects being implemented in India? Find out and write about their social impact.

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10.4 WORLD BANK GROUP INSTITUTIONS

International Development Association (IDA)

This arm of the Bank looks after the poverty alleviation and debt relief of majorly the 74 poorest countries of the World. They lend money on concessional or near zero interest rate terms. The loans are made for long term 30-40 years with interim 5-10 years grace periods. The debt relief is done through two initiatives called Heavily Indebted Poor Countries and Multilateral Debt Relief Initiative. The institution provides a range of assistance to promote economic growth, equality, employment opportunities, higher income and enhanced living standards. Major areas covered under the institute's initiatives are, primary education, basic health services, clean water and sanitation, agriculture, business climate improvements, infrastructure, and institutional reforms.

International Finance Corporation (IFC)

This arm of the Bank is involved in private sector development in member countries especially those projects which have welfare implications. The institution can help private sector entities by giving loans, taking equity stakes, stock options or by sharing profits. It may also provide venture capital and stimulate investments by other private entities and overall try to develop the capital market in developing countries. This is meant to foster private investment flows both within and across borders. The funds for these programmes are sourced from the institution's net worth, retained earnings, public and private placements of bonds and from the Bank. The major thrust has been to increase efficiency of public utilities through push towards privatisation of such services. Services like power, water, transportation, and communications have been targeted for this purpose. In terms of technical

assistance, the institution tries to help private sector entities to get select technology partners, find markets for their products and sources of low-cost finance for their expansion.

Multilateral Investment Guarantee Agency (MIGA)

Foreign investments are an important source of funds for fuelling economic growth and reducing poverty in developing countries. Observed foreign flows shows appetite for only a handful of such countries severely limiting the prospects of growth and development in countries facing internal or external problems related to the political atmosphere. MIGA comes in here and tries to channelise foreign investment in disturbed and poor countries through its initiatives. The most important of them is the political risk insurance products which can be bought by the investing companies to guard them against any problems which makes their investment bad in host countries. The Agency also provides services like technical assistance to promote investment climate, settle investment disputes and promote foreign capital flows in disturbed countries who need them the most. The Independent Evaluation Group (IEG-MIGA) was established in the year 2002 to assess MIGA's operational and developmental effectiveness. Activities to be evaluated include guaranteeing projects, technical assistance, advisory and legal services, as well as the evaluation of MIGA's institutional efficiency, efficacy and strategy.

International Centre for Settlement of Investment Disputes (ICSID)

ICSID gives a platform for the investors to settle their disputes with the host states. A need was felt for tackling the non-commercial risks of foreign investments. The members involved in the dispute can voluntarily resort to the mechanisms available with ICSID to settle their disputes. But once sought they cannot withdraw from the proceedings. Additionally, over the years given the requests by the members ICSID may also involve itself with fact finding missions related to the disputes. It now also allows cases if one of the countries involved in the dispute are not its member. Additionally, it may also involve in transactions which cannot be categorised as foreign investment but is distinct from a ordinary commercial transaction. An example can be fact finding proceedings. Further, the Secretary General of ICSID is available for appointing arbitrators or disqualifying them for disputes covered under their conventions. ICSID provides well equipped hearing rooms for the proceedings related to disputes.

Activity 3

Try to make a case study on operations of each of the arms of the World Bank. It can be a country case study, disputes between countries, insurance for foreign investments in risky countries, etc.

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10.5 DIFFERENCE BETWEEN IMF AND THE WORLD BANK

The major differences between the World Bank and the IMF can be understood through the following table.

Table 10.1: The International Monetary Fund and the World Bank at a Glance

International Monetary Fund	World Bank
... oversees the international monetary system ... promotes exchange stability and orderly exchange relations among its member countries ... assists all members--both industrial and developing countries--that find themselves in temporary balance of payments difficulties by providing short- to medium-term credits ... supplements the currency reserves of its members through the allocation of Special Drawing Rights (SDRs); to date SDR 21.4 billion has been issued	... seeks to promote the economic development of the world's poorer countries ... assists developing countries through long-term financing of development projects and programs ... provides to the poorest developing countries whose per capita GNP is less than $865 a year special financial assistance through the International Development Association (IDA) ... encourages private enterprises in developing countries through its affiliate, the International Finance

to member countries in proportion to their quotas ... draws its financial resources principally from the quota subscriptions of its member countries ... has at its disposal fully paid-in quotas now totalling SDRs 145 billion (about $215 billion) ... has a staff of 2,300 drawn from 182 member countries	Corporation (IFC) ... acquires most of its financial resources by borrowing on the international bond market ... has an authorized capital of $184 billion, of which members pay in about 10 percent ... has a staff of 7,000 drawn from 180 member countries

***Source*:** https://www.imf.org/external/pubs/ft/exrp/differ/differ.htm

Activity 4

Which of these two institutions (IMF and World Bank) are more beneficial for poor countries? Explain with the help of appropriate case studies.

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10.6 INTERNATIONAL MONETARY SYSTEM

The nations transact with each other mainly through trade and capital flows. Net transactions have to be settled at regular intervals. While engaging in such transactions some of the countries may face situations where the payment obligations are more than their receipts. In that case such disequilibrium in Balance of Payments (BoP) is either met through foreign exchange reserves or through borrowed funds. Hence, there is a requirement for countries and institutions to act as supplier of such reserves. Amount of such reserves that would be

demanded depends on the speed of adjustment of BoP and the institutional framework of the world economy.

Exchange rate system followed by the countries also impacts the amount of reserves that can be demanded. In a completely market determined exchange rate system the movement in exchange rate brings the BoP back to equilibrium reducing the requirement for international reserves. In case of a fixed or pegged exchange rate system in order to maintain a certain level of exchange rate the requirement for foreign exchange reserves increases. The other function of international reserves is to facilitate government intervention in foreign exchange rate markets. Higher the volume of such activities higher is the requirement of international reserves.

The other major factors impacting the demand for international reserves is the speed of automatic adjustment, policies aimed at restoring BoP equilibrium and international coordination of economic policies. If the automatic adjustment mechanism takes time, then the demand for international reserves goes up. For example, a BoP deficit triggers a depreciation of home currency which enhances exports and reduces imports and automatically moving the country towards equilibrium. But if rigidities cause the adjustment to be slow then the country has to resort to international reserves either owned by them or borrowed from others. Similarly, if the economic policies geared towards restoring equilibrium takes time to achieve the desired outcomes again the demand for international reserves go up. The coordination of economic policies across countries has been the objective of institutions like IMF. Groups like Organisation of Economic Cooperation and Development (OECD) and monetary unions like European Union (EU) are efforts towards this direction. More the coordinated are the economic policies across countries lesser would be the need for international reserves.

The supply of international reserves can be owned or borrowed. They are majorly in the form of gold, acceptable foreign currencies and Special Drawing Rights (SDRs). Gold has always been a major form in which international reserves were kept. During the years of the Gold Standard System (1880-1914), gold served as a means of payment, unit of account and store of value. The national currencies were denominated in terms of gold and since its supply was not that flexible it disciplined the Central Banks in the sense that excessive money growth was not possible. Countries stood committed to exchange gold for their currencies freely. The importance of gold in money supply however drastically came down before WWI and the

importance of paper money and demand deposits in banks increased manifold. At the end of WWI when inflationary tendencies were high there was a demand to return back to the gold standard. US was one of the first countries to announce the return to gold standard. But it turned out to be an uphill task and due to the onset of Great Depression it was no longer possible to maintain the system and countries one by one abandoned the gold standard.

After the WWII when IMF came into being the world moved on to what is known as the Gold Exchange Standard. Gold was considered as a unit of account. US took the responsibility of being the international banker. Dollar was denominated in terms of gold. All other currencies were denominated in terms of gold or gold content of dollars. US agreed to freely convert dollar to gold whenever presented with the currency by the other countries. Dollar thus served as a reserve currency. This system was perfect till the time US gold reserves were higher than outstanding dollar liabilities. But as gold reserves fell short of such liabilities fear creeped in to the minds of the countries holding dollars that the US might devalue the dollar leading to losses for them. On 1st January 1975 gold was abolished as a unit of account and could be freely traded by countries like other commodities. Use of gold was discontinued by IMF. Recent data shows that the percentage of international reserves kept in terms of gold is less than 1%.

Given the expansion of international trade and capital flows, dollars and gold was found to be inadequate to serve as international reserves. The need was thus felt for an additional international reserve currency. SDRs were contemplated as a unit to decide the contributions of the members to IMF. The value of SDRs was determined by the basket of acceptable currencies like dollars, yen, pound and euro. The proportion is decided on the basis of trade in these currencies in the last five years. SDRs are not claims on IMF but on the countries, which issue the acceptable currencies on the basis of which value of the SDRs is determined. Countries holding SDRs can freely convert them into these currencies.

The nations can access international reserves from two special windows of IMF. One is the IMF Drawings. In this the nations in need of international reserves can buy foreign currency by pledging their home currency and agree to buy them back at some future date. This is normally extended till 50% of the quota for that country is reached. Additional amounts can be accessed through special permissions. The second option is to access credit through IMF's General Arrangements to Borrow. G10 countries agreed to give additional funds to IMF to

finance this facility. This is over and above the amount accessed through IMF Drawings when the latter is found to be inadequate to finance BoP deficits.

Activity 5

1. Try to find out the various exchange rate systems followed by countries across the world.

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2. Does a flexible or fixed exchange rate result in a more stable financial system? Read materials on internet and find out the answer to this question.

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3. India faced a severe BoP Crisis in 1990. Develop a story on the causes and consequences of the Crisis and the impact of IMF conditionalities on India. Were the policies beneficial for India? Explain.

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10.7 SUMMARY

Process of globalization gave rise to the need for an orderly financial system. The IMF and the World Bank can be seen as institutions which were created for maintaining a stable international financial system. Specifically, IMF was entrusted with the job of assisting nations in payment problems. In return for such assistance the countries were supposed to follow prescribed policies. Such policies while successful in some countries created further problems in others. The World Bank majorly looked at assisting countries in reducing poverty. Private enterprises in such countries were also encouraged through assistance from IFC an important arm of the Bank. The current role of IMF is more flexible than in the past and is seen as more conducive for the developing countries. The World Bank on the other hand is engaged in poverty reduction and helps build smart infrastructure in developing countries. Countries thus have means to stabilize their financial system and address poverty related problems which may be beyond their capacities to tackle.

10.8 KEY WORDS

Protectionism: Tendencies of the countries to create barriers to flow of goods, services and people.

Bretton Woods Conference: A Conference of 44 allied countries held at Bretton Woods in USA to discuss the course of the future world order after the World War II.

Special Drawing Rights (SDRs): is an international reserve currency created by IMF whose value is determined by a basket of currencies comprising of US dollars, Euro, Renminbi, Yen and GBP.

Structuralists: The proponents of this view feel that the result of the world financial order is higher inequality and distorted development across countries.

Flexible Credit Line: This facility is given by IMF to countries to prevent crisis but having good track record and past economic performance.

Precautionary and Liquidity Line: Funding under this facility is for those countries facing difficulties but having sound fundamentals but ineligible for Flexible Credit Line.

Public Goods: Goods which cannot be exclusively made available to a person or persons. It is difficult to prevent someone from using it once it is made available to some person or persons, for example, road.

Gold Standard: In this system the currencies of countries were directly linked to the value of gold.

Gold Exchange Standard: The reserve currency (US dollar) was denominated in terms of gold. All other currencies had a fixed exchange rate with dollars. The country issuing the reserve currency stood ready to exchange that currency for gold with central banks of other currencies.

10.9 SELF - ASSESSMENT QUESTIONS

1. Explain why it was felt that unilateral assistance by countries like USA was not enough? Do you think the world needed institutions like IMF and World Bank? Discuss.
2. Explain how during Gold Standard system the international financial system operated.
3. What was the Bretton Woods system of exchange rate arrangement? Why did it come to an end?
4. Which are the most important functions of IMF according to you? Explain.
5. Distinguish the role of the World Bank from that of IMF. To tackle poverty which one of these Institutions would be more effective? Explain.
6. Given the criticisms of IMF's policies what new initiatives have been taken by the Institution? Do you think they would be effective? Explain.
7. How is Gold Exchange Standard different from Gold Standard?
8. What are the various arms of the World Bank? How do they facilitate international business? Explain.

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UNIT 11 BALANCE OF PAYMENTS (BoP)

Objectives

After reading this unit you should be able to:

- explain the concept of Balance of Payments (BoP) of a country and its major components;
- highlight the importance of Balance of Payments (BoP) for an economy; and
- analyse India's Balance of Payments (BoP) at present.

Structure

11.1 Introduction

11.2 Importance of Balance of Payments (BoP)

11.3 Components of Balance of Payments (BoP)

11.4 Basic BoP Accounting Rule

11.5 Equilibrium in Balance of Payments (BoP)

11.6 Balance of Trade (BoT) and Balance of Payments (BoP)

11.7 Factors Affecting the Balance of Payments (BoP)

11.8 Balance of Payments (BoP) and the Central Bank

11.9 Trends in India's Balance of Payments (BoP)

11.10 Summary

11.11 Key Words

11.12 Self-Assessment Questions

11.13 References/ Further Readings

11.1 INTRODUCTION

The Balance of Payments (BoP) for a country can be defined as a systematic record of all the transactions between the economic units of one country (such as households, firms and the government) and the rest of the world in any given period of time. This includes all the transaction records made among the individuals, corporates and the government and helps in keeping the flow of funds in track, to develop the economy as a whole. Balance of Payments (BoP) is the sole integral determinant of the health of an economy as well as its

relations globally. It portrays the overall transactions of an economy with the other global economies during a given time period in a systematic and prudent manner.

11.2 IMPORTANCE OF BALANCE OF PAYMENTS (BoP)

The Balance of Payments (BoP) of a country is important because:

- The BoP reflects the financial and economic status of a country;
- The BoP may act as an indicator to determine whether a country's value of currency is appreciating or depreciating;
- The BoP statement helps the government in making decisions on fiscal and trade policies;
- The BoP statement provides vital insights into the economic dealings of a country with the rest of the world.

A close study of the BoP statement and its components would help in identifying the trends which might be beneficial or harmful for an economy and thus, helps in taking appropriate economic measures.

11.3 COMPONENTS OF BALANCE OF PAYMENTS (BoP)

There are **two** main components of Balance of Payments (BoP):

- Current Account
- Capital Account

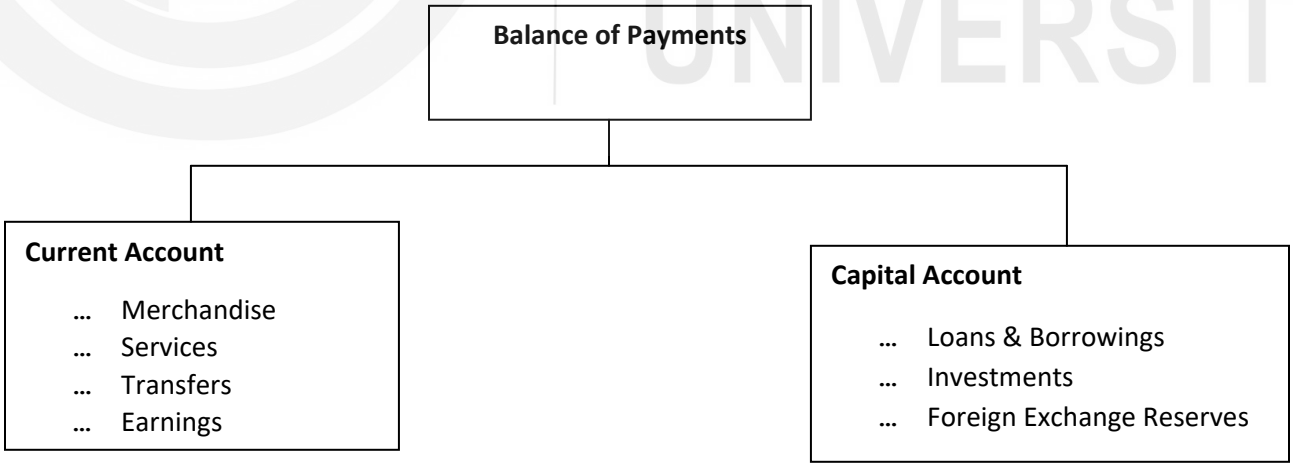


Figure 11.1: Components of Balance of Payments (BoP)

Current Account

The current account in the BoP, comprises of the transactions in goods and services, alongside transfers during the current time period.

Current Account = (value of exports – value of imports) + net transfers from abroad

= net exports + net transfers from abroad…… **(i)**

The net exports are also termed as the *trade balance*, which is the net sum of a country's exports and imports in goods as well as in services. Trade in services is often said to be invisible as they cannot be seen to cross national borders. For instance, when a foreign country pays for the maintenance of its factory in the domestic home (or domestic) country or for the services by a home resident who is working in that foreign country, then the home country is said to be exporting a service. Tourism, is one major service export.

The trade balance reflects a surplus (positive) if the value of exports of a country exceeds its imports while it is said to reflect a deficit (negative) if the value of imports of a country is higher than its exports.

Transfers to and from abroad may be in the form of gifts or remittances that residents of one country might send (receive) to (from) another country. If the net transfers from abroad is positive, it means that transfers from residents in abroad are greater than that sent by domestic residents to abroad. Similarly, the net transfers from abroad is negative, if transfers from foreign countries are lesser than the transfers to abroad. Net foreign aid received by a country during a particular period is also a part of transfers.

If the right-hand side of the equation (i) is positive (negative), then the current account is in surplus (deficit). It must be noted that large transfers from abroad may put the current account in surplus, even if the net exports is negative. However, to keep things simple, the term "net transfers" will be ignored in the subsequent analysis and hence, the current account will comprise of net exports or trade balance only.

Capital Account

The capital account records all transactions in assets. An asset may include any one of the type in which wealth can be held, for instance, stocks, bonds, government debt, etc. Purchase of an asset records a deduction in the capital account. If an Indian is purchasing a US Car company, then it is recorded as debit in the capital account of India (as the Indian has to pay in dollars which means that the foreign exchange is going out of India). The

sale of assets, for instance, the sale of share of an Indian company to a US customer is recorded as a surplus in India's capital account (as sale of assets to foreign country will bring foreign exchange into the country).

Taking the two accounts together, the BoP can be summed up as:

Balance of Payments = current account + capital account…… (ii)

BoP is in surplus (deficit) if both the current and the capital account (combined) has a surplus (deficit). Thus, a deficit in current (capital) account doesn't alone lead to a BoP deficit. It has to be outweighed by a large surplus in the capital (current) account.

Thus, it is very important to keep the basic rule of BoP accounting in mind.

Activity 1

Can you deduce which of the following belong to the capital or current account of India's BoP?

a) Purchase of a share in Indian company by an American mutual fund.
b) Export of automobile parts by an Indian manufacturing company to London.
c) A French investor making a deposit in an Indian bank.

11.4 BASIC BoP ACCOUNTING RULE

All transactions leading to a net receipt of foreign exchange creates a credit (surplus) in the corresponding account, whereas all transactions leading to net payment to foreign countries create a debit (deficit) in the corresponding account.

When the value of exports for a country exceeds its imports, it accumulates more of foreign exchange, leading to a current account surplus for the country. Similarly, if the sale of domestic bonds to foreign countries (borrowing from a foreign country) exceeds the purchase of foreign bonds (lending to a foreign country), then there is a capital account surplus for the domestic country. A foreign loan repayment, however is recorded as a

debit in the capital account as it involves outflow of payments in foreign currencies. A deficit (surplus) in the capital account is termed as net capital outflow (inflow) from the country. A current account deficit in a country is necessarily being offset by the capital account surplus in the economy.

Double – entry Book keeping

The BoP accounting follows the system of double – entry bookkeeping in which all the transactions are recorded twice, one as a credit and the other as debit. Any transaction which leads to payment from (to) abroad is a credit (debit). The payments are recorded as an offsetting entry to the transactions which are its cause.

Suppose a country (say, India) exports automobile parts to a foreign country (say, US). The US will have to pay for the purchase, which will be a current account surplus for India. The payment can be made in any form, either through granting of credit or bank drafts by the Indian exporter to the US recipient. In both the instances, India's foreign reserves increase and an offsetting deficit is recorded in India's capital account.

According to the system of double – entry bookkeeping, the BoP always balances in principle, where the total value of credit records will be equal to that of the debit records. However, this does not ever happen in practice due to proper unavailability or recording of data. Thus, a record for **errors and omissions** are included to make the overall balance in payments zero.

11.5 EQUILIBRIUM IN BALANCE OF PAYMENTS (BoP)

The Balance of Payments of a country depends on the records of transactions both in the current as well as in the capital account. A surplus in the capital (or current) account records an inflow of foreign exchange into the country (supply of foreign exchange exceeds its demand) whereas, a deficit in the current (or capital) account leads to an outflow of foreign exchange (demand of foreign exchange is higher than its supply) from the country.

Now that we know what Balance of Payments (BoP) means and how it works, let us try to understand what it means to have the Balance of Payments of a country in equilibrium. A country can have its BoP in equilibrium only when the demand for its foreign exchange reserves equals the supply of foreign exchange i.e. when both the inflow and outflow of foreign exchanges from the country are equal.

If a country's inflow of foreign exchange exceeds its outflow, it is said to have a favourable Balance of Payments or **BoP surplus**. Similarly, if the country's inflow of foreign exchange is exceeded by its outflow, it is said to be having an unfavourable BoP or **BoP deficit**.

If the BoP moves against the country, necessary adjustments must be made to improve the same by encouraging more of exports (both in goods and services) and less of imports. Again, a favourable Balance of Payments of

an economy may lead to encouraging of imports (for both goods and services), purchase of foreign assets or granting of foreign aid to other countries in need. A country can never have a permanent favourable or unfavourable Balance of Payments. What needs to be maintained is that, the total liabilities and total assets, as of individual countries, must balance out in the long-term.

An equilibrium in the Balance of Payments, thus is an indicator of a sound economy. Disequilibrium in the BoP is a short-term phenomenon and is balanced out by the supply and demand for foreign reserves possessed by the economy.

11.6 BALANCE OF TRADE (BoT) AND BALANCE OF PAYMENTS (BoP)

One might have a question as how is the Balance of Trade different from that of the Balance of Payments. Are they related or are two different concepts? The answer to this is as follows:

The Balance of Trade (BoT) is a major part of the transactions in the current account of the Balance of Payments. It is nothing but the net exports (difference between value of exports and the value of imports). The BoT can either be positive, negative or zero and determines if the country has incurred a net profit or loss from the net exports. It depends only on the export and import of goods and services and doesn't take into account the transfers and financial asset transactions. A positive BoT may result in surplus of foreign reserves in the country, which can be a major determinant of a sound economy. A negative BoT can lead to outflow of foreign reserves and can lead to disequilibrium in the economy's BoP. The ideal situation turns out when the BoT equals zero (Net exports = 0), which may not necessarily be true in all cases.

The Balance of Payments (BoP) is a broader concept and includes transaction records from Trade Balance, net transfers, and transactions in financial assets (capital account transactions). The BoP is an indicator of whether a country is having surplus or deficit of foreign reserves. Any receipt of payments, in the form of export payments, gifts or remittances or selling of bonds leads to a surplus in the BoP whereas any payment such as payment for imports, transfers to abroad or purchase of foreign bonds leads to deficit in the BoP. The BoP is a crucial indicator of whether the country is having a stable economy or not.

11.7 FACTORS AFFECTING THE BALANCE OF PAYMENTS (BoP)

The factors which affect the Balance of Payments (BoP) are divided into two groups:

- The factors affecting the current account
- The factors affecting the capital account

The factors affecting the Current Account

The current account may be affected by the following factors:

1. *Rate of Inflation in the Resident (domestic) Country*: A higher rate of inflation in the domestic economy, compared to its trading partners, lead to:
   - cheaper imports which lead to increase in purchase of foreign goods. Imports therefore, tend to rise with rise in the inflation rate; and
   - rise in cost of the exports in the foreign market, as a result of which the foreign nationals will less likely be purchasing the domestic country's goods. Exports, therefore tend to decline.

   Thus, rise in imports and fall in exports will lead to a current account deficit.

2. *National Income:* According to most of the empirical studies, an increase in national income of a country, in comparison with its trading partners, may lead to:
   - higher tendency among domestic residents to purchase more of foreign products which will generate a significant rise in imports and thus, more outflow of foreign reserves from the country leading to current account deficit; and
   - in some exceptional cases, a rise in national income may also lead to improvement in the current account as it may be associated with increase in production capacity in the economy and surplus generation of exports.

3. *Import Restrictions by Government*: Imposition of taxes (such as tariffs) by the government on the goods imported, leads to a rise in its prices in the domestic economy. As a result, domestic residents will reduce their purchase of foreign products, thereby improving the current account.
   Sometimes, the government also imposes quota restrictions on its imports which again, lead to decline in the imports and generates a current account surplus.

4. *Exchange Rate*: The Exchange rates measure the prices of the domestic currencies in terms of the foreign currencies. The Current account is a function of Real Exchange Rate (RER). A higher RER is associated with lowering of exports and increase in imports whereas a lower RER is associated with higher number of exports and decline in imports. Thus, it can be interpreted that lowering of RER (which might happen through devaluation of currency) might lead to improvement of current account.

The factors affecting the Capital Account

Capital movement across borders are affected by the following factors:

1. Imposition of tax by the government on the income accumulated by the domestic investors, who have invested in the foreign markets. This will lead to lower outflow of capital.
2. Economic liberalization might have an impact on the capital account.
3. An expected change in the exchange rates may affect the flow of capital as it tends to have an impact on the expected rate of return in the foreign investment.
4. Changes in the interest rates, in comparison to other countries, may tend to affect capital flows across borders. A higher domestic interest rate may lead to lower capital flows into the country whereas a reduction in domestic interest rates may tend to have greater capital flows into the country.

Activity 2

India faced a severe BoP Crisis in 1990s. Look at the balance of payments account (you can get it from Economic Survey of 1989-90 and 1990-91) and try to find the figures which reveal the crisis. Write down a brief note on what led to such a crisis and how was it addressed.

11.8 BALANCE OF PAYMENTS (BoP) AND THE CENTRAL BANK

The Central Bank of all countries holds reserves of foreign currencies, which they can use to finance the deficit in the current account. For instance, a country, say India, has a deficit in current account worth Rs. 200 and a surplus in the capital account worth Rs. 180. Then, there is an overall BoP deficit of Rs. 20. If the Central Bank (in this case, RBI) intervenes, then it can meet the deficit by selling equivalent amount of foreign exchange to its importers for payments to foreign countries. However, in case of a capital account deficit, sale of foreign exchange by RBI may be required for foreign lending or repayment of foreign loans by the Indian residents.

Such purchase and sale of Foreign Exchange Reserves by the Central bank are termed as ***official reserve transactions***.

An overall surplus in the BoP leads to purchase of foreign exchange assets by the Central Bank, which expands its stock of foreign reserves and hence increases the money supply in the economy. An overall BoP deficit, on the other hand leads to sale of foreign exchange reserves by the Central Bank which leads to depletion of its foreign exchange reserves, thereby lowering the money supply in the economy.

Let us consider an example to understand. Suppose US has a current account surplus of $60 million and a capital account deficit of $40 million. This implies that:

i) there is an overall BoP surplus of $20 million;
ii) if the Federal Reserve intervenes, then it will purchase foreign exchange reserves, equivalent to $20 million and add to its stock of foreign reserves; and
iii) there is an increase in the net foreign reserves of the Federal Reserve.

In case, the Federal Reserve doesn't want to intervene in buying and selling of foreign exchange reserves, then the exchange rate (the value of home currency relative to foreign currencies) will automatically adjust to eliminate the deficits or surpluses in the BoP. Such a system, where the Central Bank of a country doesn't intervene in the foreign exchange market is called as fully flexible system of exchange or a clean float of the currency.

Activity 3

Suppose that India records a current account deficit of US$ 20 million and a capital account surplus of US$ 36 million. What can you conclude from this information?

- Is India's overall BoP in deficit or surplus?
- If RBI tries to intervene, will it buy or sell India's Foreign Exchange assets? What will happen to overall money supply in the economy?
- If RBI doesn't intervene, how will it impact India's exchange rate system?

Should a Current Account Deficit (CAD) always be a situation of alarm?

In an open economy, we know that

$Y = C + I + G + X - M$

or

$M - X = CAD = (C + I + G) - Y$

Where,

Y = Income of the economy

C = Expenditure incurred on consumption

I = Expenditure on investments

G = Expenditure incurred by the Government

X = Value of exports

I = Value of imports

X– M = Net exports (or trade balance).

Here, (C + I + G) is the aggregate demand or planned expenditure of an economy and Y is the income of an economy. In case of a current account deficit (CAD), a country is spending more than its income (on accumulating imports) and builds up debts in the outside world. Whether a CAD is a cause of alarm or not, depends on the nature of expenditure involved in the economy. A CAD will not be an alarming cause as it might be offset with the help of some productive I or G in the economy. The debts plus interest (that accumulates as result of deficit) will automatically be repaid through the growth dividends generated out of those productive investment or government expenditures. In such a scenario, a CAD will be a sign of health of a robust economy. If the CAD is triggered by more of consumption or unproductive investment or government spending, then the CAD will indeed turn out to be a severe cause for alarm in the economy.

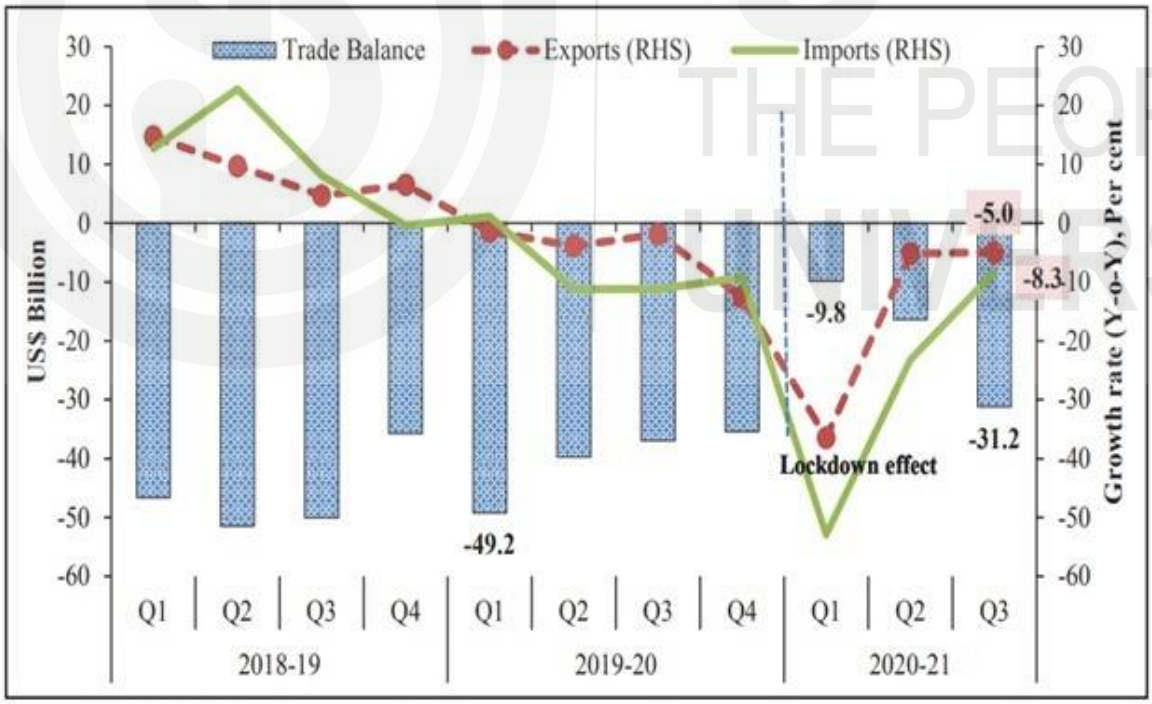
How to Finance a Current Account Deficit (CAD)?

As discussed earlier, CAD may or may not be necessarily harmful for an economy. However, CAD can be financed through various capital inflows such as:

- Portfolio investments
- External commercial borrowings
- Foreign Direct Investments
- NRI deposits

11.9 TRENDS IN INDIA'S BALANCE OF PAYMENTS (BoP)

During the first quarter of the FY 2020-21, India witnessed a sharp decline in both its exports and imports in line with the contraction in global trade. The decline in imports exceeded that of exports, which led to a smaller trade deficit of US$ 9.8 billion compared to US$ 49.2 billion in Q1 of FY 2019-20. India recorded a trade surplus only in the month of June, 2020 after a period of 18 long years. A gradual improvement in India's merchandise trade was witnessed post unlocking of the economy due to Covid-19 pandemic, from June, 2020

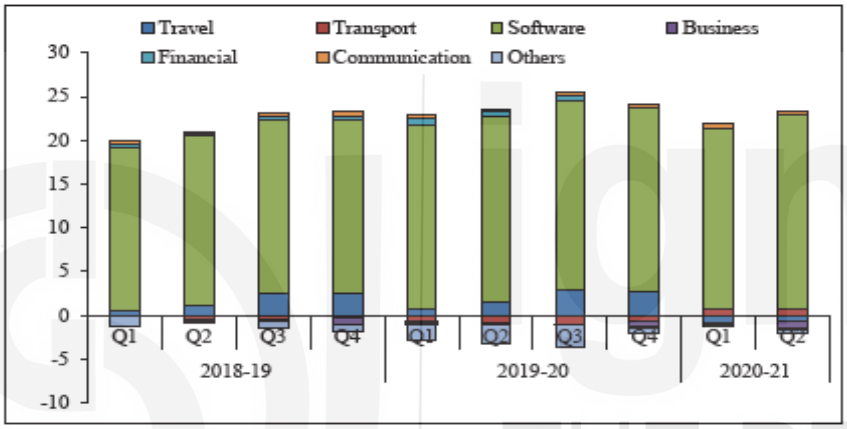


Source: Economic Survey 202-21.

Figure 11.2: Merchandise Trade Balance, Exports and Imports

onwards. The trade-deficit during April-December, 2020-21 was US$ 57.5 billion compared to US$ 125.9 billion in April-December, 2019-20. Figure 11.2 illustrates India's merchandise trade during the FY 2018-19, 2019-20 and Q1 of 2020-21.

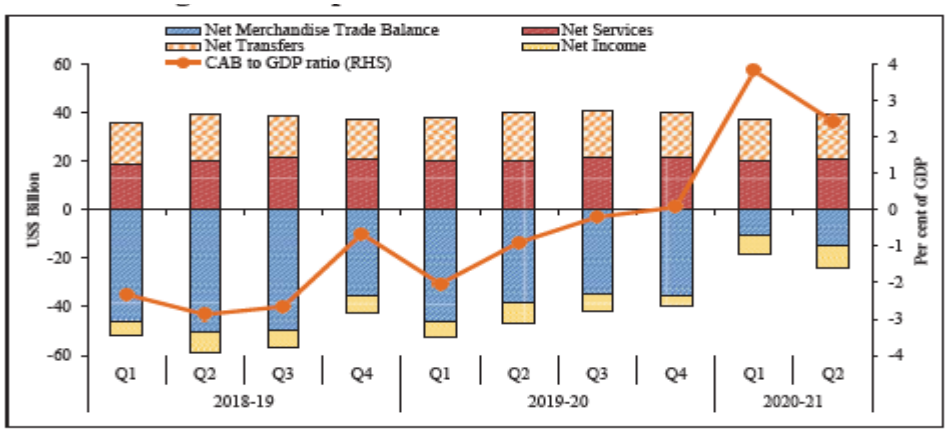
Net service receipts remained stable, amounting to US$ 41.7 billion, during April- September, 2020 compared to US$ 40.5 billion in the corresponding period in 2019. This is because of the international mobility restrictions and falling remittances on the onset of the covid 19 pandemic. The quicker recovery of the service sector was mainly driven by the software services which amounted to 49% of the total service exports in 2020. Figure 11.3 shows the composition of the net service exports of India during the period 2018-2021.



Source: Economic Survey 2020-21.

Figure 11.3: Composition of Net Services Exports

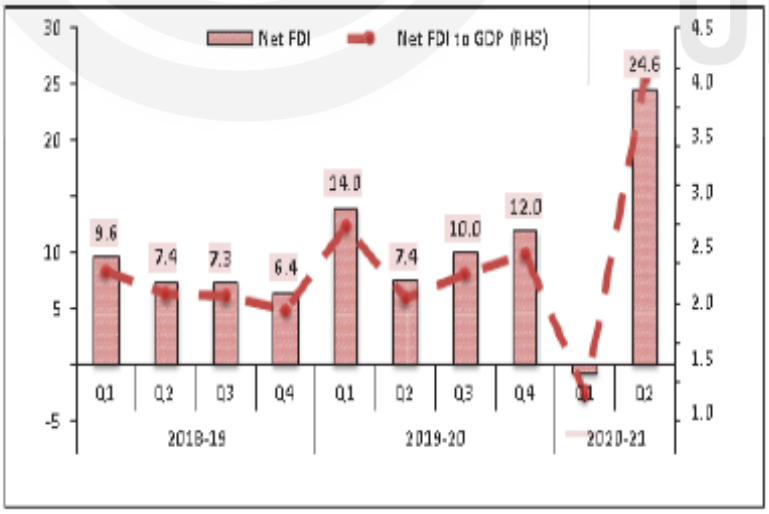
India recorded a current account surplus (which is 0.1 per cent of GDP) in Q4 of FY 2019-20, after a gap of 13 years after Q4 of 2006-07. This has been possible on account of a lower trade deficit and a steep rise in the net invisible receipts. The surplus continued successively in the Q1 and Q2 of FY 2020-21. A sharp fall in the merchandise exports and a lower outgo for travel services led to a sharper decline in current payments, by 30.8 per cent, than current receipts (by 15.1 per cent)- which led to current account surplus of US$ 34.7 billion (which is 3.1 per cent of GDP). It is expected that India will tend to end with a current account surplus of at least 2 per cent of GDP, given the trends in its imports of goods and services, after a period a gap of 17 of GDP trends in its goods and a period a years (Figure 11.4).



Source: Economic Survey 2020-21.

Figure 11.4: Composition of Current Account Balance

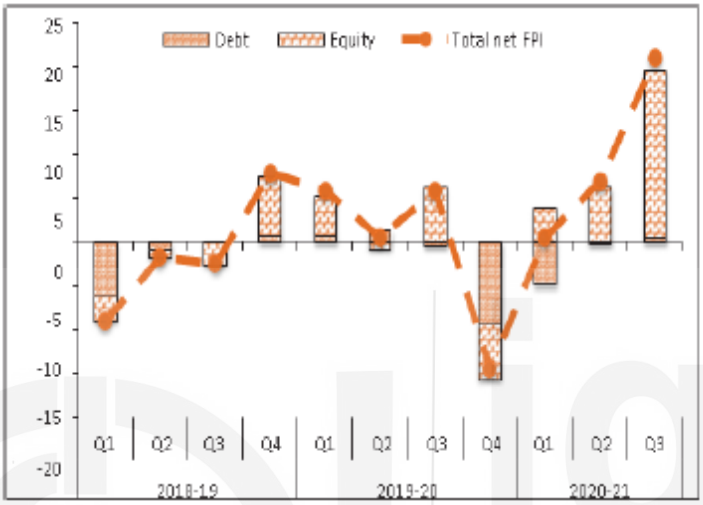
Net capital flows witnessed a decline in the first half of FY 2020-21 at US$ 16.5 billion, as against US$ 40.0 billion in the first half of FY 2019-20, due to the net repayments of the External Commercial Borrowings and decline in the banking capital. However, net foreign investments saw an increase at US$ 31.4 billion in the first half of FY 2020-21 as against US$ 28.7 billion in the corresponding period in 2019-20. Foreign Direct Investments (FDI) recorded an inflow of US$ 27.5 billion, during April-October, 2020, which is 14.8 per cent higher than the second half of FY 2019-20. Computer hardware and software accounted for the highest FDI inflows amounting to US$ 17.6 billion in April- September, 2020 compared to US$ 4.0 billion in April-September, 2019 (Figure 11.5). Addition of Indian stocks to the Morgan Stanley Capital International (MSCI) also played a major role in attracting foreign capital inflows.



Source: Economic Survey, 2020-21

Figure 11.5: Net FDI flows

Foreign Portfolio Investments (FPI) too, recorded a net inflow of US$ 28.5 billion during April-December, 2020 as compared to US$ 12.3 billion in the corresponding period in 2019. This increase in the net FPI resulted on the grounds of immense support provided to the Indian equities by the abundant global liquidity, better corporate earnings in the successive quarters and better management of the Covid-19 economic recovery prospects (Figure 11.6).

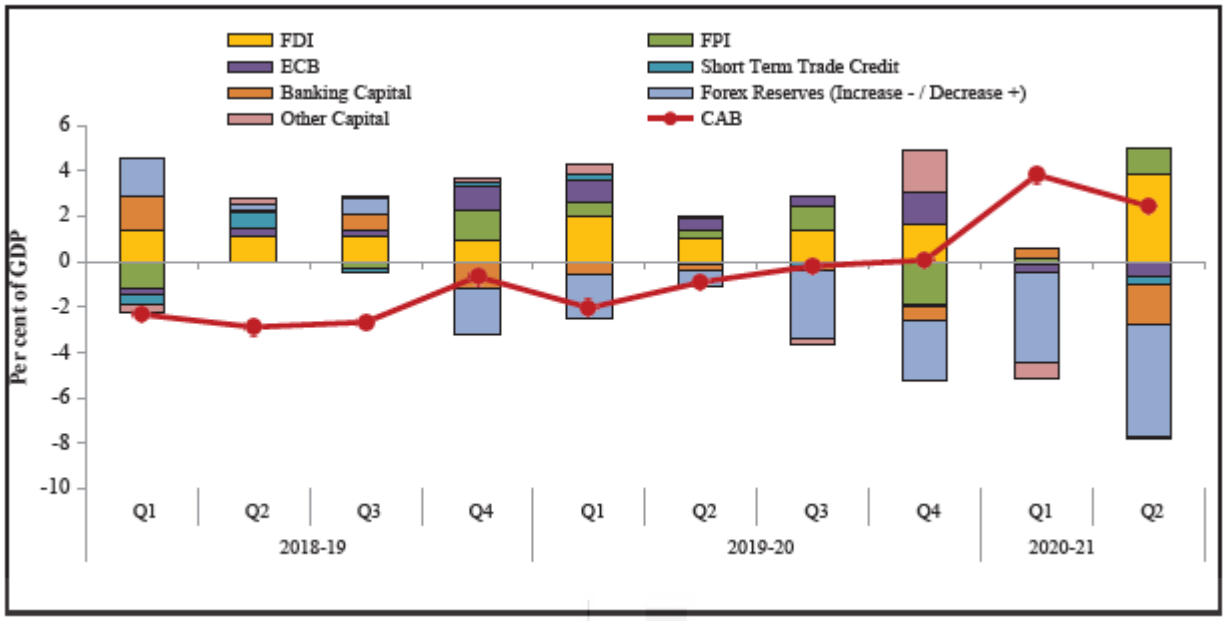


Source: Economic Survey 202-21.

Figure 11.6: Net FPI flows

India's external debt stood at US$ 556.2 billion, in end-September, 2020, which recorded a decline by US$ 2.0 billion over that in end-March, 2020. External Commercial Borrowings (ECBs), which is the largest component of India's external debt, recorded an amount of US$ 207 billion at the end-September, 2020, which is 5.8 per cent lower than that in end-March, 2020. The stocks of NRI deposits, the second largest component of India's external debt, rose to US$ 137.3 billion (by 5.1 per cent) compared to that in end-March, 2020. The (import-financing) trade deficit, the third largest component, shrank by 2.0 percent to US$ 99.4 billion compared to that in end-March, 2020. Government debt, on the other hand, increased from US$ 100.9 billion in the end-March, 2020 to US$ 103.6 billion in the end-September, 2020.

To sum up, India, being an emerging market economy, typically runs a deficit in the current account which is being offset by a corresponding capital account surplus. However, India has been witnessing a current account surplus since Q4 of FY 2019-20 along with increased capital inflows which have led to an overall BoP surplus. Figure 11.7 below, shows the trends in India's overall BoP during the period 2018-2021.



Source: Economic Survey, 2020-21.

Figure 11.7: Trends in India's BoP

Activity 4

1. List the major countries with which India's merchandise trade balance is positive during the financial years 2019-20 and 2020-21.

2. List the top 10 export commodities of India during the FY 2019-20. Also find out the top 10 export destinations of India during the FY 2019-20.

11.10 SUMMARY

The Balance of Payments (BoP) of a country summarizes all payment transactions and receipts by individuals, firms and the government in a given time period. It has two major components – the current account and the capital account. The current account transactions mainly include the net value of imports and exports of a country alongside net transfers from abroad. The current account transactions mainly include the transactions involved in purchase and sale of assets across the geographical boundary. An inflow of funds (in the form of foreign exchange reserves) leads to a BoP surplus in a country whereas an outflow of funds result in a BoP Deficit. A surplus in BoP leads to purchase of foreign exchange reserves by the Central Bank, thereby increasing its stock of foreign reserves and money supply in the economy. A BoP deficit, on the other hand is characterized by sale of foreign exchange reserves by the Central Bank, thereby reducing the money supply in the economy. The balance of payments can be in equilibrium, only if the demand and supply of foreign exchange reserves are equal i.e., when the inflow and outflow of foreign exchange reserves from the country, are equal.

11.11 KEY WORDS

Quota Restrictions: Quota restrictions are usually a form of tariff, imposed by the Government of a country, on the quantity of the imported goods.

Tariffs : A tax or a duty imposed on the imports or exports.

Real Exchange Rate (RER): Rate of valuation of home country currency in terms of the foreign country currency, given the relative prices of both the countries. It is the rate at which goods or services are exchanged between two countries.

Portfolio Investments: Financial flows targeted towards stocks, bonds and other assets in order to gain from returns or growth in value of such items. They are generally of short-term nature without intension to control.

External Commercial Borrowings: Loans made to entities in a country by non-residents in foreign currency.

Foreign Direct Investments (FDI): These are financial flows which target control of the entity in which investments are made.

NRI Deposits: These are foreign currency deposits made in banks in India by non-resident Indians.

11.12 SELF - ASSESSMENT QUESTIONS

1. Define Balance of Payments (BoP)?

2. Why is Balance of Payments (BoP) important for a country?

3. What are the components of Balance of Payments (BoP)? Briefly explain.

4. When is the Balance of Payments (BoP) said to be in equilibrium?

5. What is the difference between the Balance of Trade and Balance of Payments?

6. How does the Central Bank of a country play a role in influencing the Balance of Payments (BoP)?

7. Do you think that a current account deficit is always a cause of alarm? How can it be financed?

8. Can you elaborate on India's overall Balance of Payments (BoP) situation during the FY 2017-18 and 2018-19?

11.13 REFERENCES/ FURTHER READINGS

UNIT 12 FOREIGN TRADE

Objectives

After reading this unit you should be able to:

- define the concept of international trade and the need for it;
- state the advantages and disadvantages of international trade;
- identify the types of trade barriers and the initiatives taken to remove these barriers; and
- analyse recent trends in India's foreign trade.

Structure

12.1 Introduction

12.2 Brief Historical Overview

12.3 Need for International Trade

12.4 Advantages and Disadvantages of International Trade

12.5 Theory of Absolute and Comparative Advantage

12.6 Intra- Industry Trade among Similar Economies

12.7 Types of Barriers to International Trade

12.8 Measures to Reduce Barriers to International Trade

12.9 India's Foreign Trade: Recent Trends

12.10 Summary

12.11 Key Words

12.12 Self- Assessment Questions

12.13 References/ Further Readings

12.1 INTRODUCTION

We all exist in a global marketplace. The clothes up in your wardrobe might be designed and made in Italy or China. The car that you own might be from Japan or Korea. The fancy and latest smart phone that you possess might be made in Korea or China or Japan. The toy that you have gifted your child on her 5th birthday, might be made in China. The laptop that you are working on, might be developed in UK. As an employee, your job might be related to airplanes, cars, computers, farming, machinery or other technology related industries, such that the major proportion of the sales of your company and your salary, in turn, gets generated from the exports of such products. In short, we all are connected through international trade, which has shown an immense growth in the last few decades.

International Trade refers to the exchange of goods and services between the countries. In other words, international trade simply means imports and exports of goods and services. Export refers to the selling of goods and services out of the country while import refers to flow of goods and services into the country. From time immemorial trade has taken place through land and sea routes. Trade helps countries to boost their productivity by concentrating on producing goods in which they are competitive. Trade also helps to increase efficiency of world production under certain conditions. Given the advancement in transport and communication the dimensions have changed over time. Costs have come down significantly and thus countries trade more today than they used to even 50 years ago. The progress of trade however has been bumpy with occasional protectionism halting its flow. Currently the world is going through such a crisis. But history has shown that trade is one of the vehicles through which world GDP growth can be influenced in the positive direction.

12.2 BRIEF HISTORICAL OVERVIEW

The exchange of goods and services among people (more commonly the Barter system of exchange) is an age-old practice. Several political ideologies evolved since the late Renaissance period and has continued up to World War II and have defined the world trading pattern according to their own beliefs.

According to the **mercantilists**, who dominated during the 16-18th century:

- Acquisition of wealth, in the form of gold, by a nation is of utmost importance.
- A nation can increase as well as benefit from trade only at the cost of other nations' welfare. This led to imposition of price and wage controls, promoting of domestic industries, exports of finalised

goods and imports of raw materials while limiting the exports of raw materials and imports of finalised goods.

A strong opposition against the mercantilists came up towards the latter half of the eighteenth century, in the form of **Physiocrats** (some French economic thinkers called themselves so as they supported **Liberalism**) who demanded liberty in both production and trade. This led to strong opposition against excessively high and often prohibitive custom duties and tariffs, and negotiations of trade agreements with the more powerful foreign countries. A major success of this ideology came in the form of the Anglo-French trade agreement of 1860, according to which the French protective duties were lowered to a maximum of 25 per cent within 5 years along with free entry of all French products except wine in Britain.

In the middle of the nineteenth century, there was an emergence of **protectionist measures of trade**. The protective customs policies shielded many economies from the foreign competition. The French Tariff of 1860, for example, charged extremely high rates on British products, more precisely, 60 percent on pig iron, 40-50 percent on machinery and near about 600-800 percent on woollen blankets. Transport costs between the two countries were an additional layer of protection imposed.

The latter half of the nineteenth century witnessed Germany to follow systematically protectionist policy followed by the US raising its duty rates sharply based on the McKinley Tariff Act of 1890.

The protectionism in the last quarter of the nineteenth century weren't much stringent. Quantitative restrictions were null and void, custom duties were low and stable, currencies were freely convertible into gold, lesser issues with Balance of Payments and free factor mobility was allowed across borders.

Post the World War I, in the **first half of the twentieth century**, trading conditions were dead. World trade disrupted to such an extent from where recovery was almost impossible. It was further followed by the Great Depression of 1930s, that witnessed mass unemployment levels, giving rise to the **mercantilists' system of trade**, through imposition of protective measures. Most of the

countries attempted to improve their Balance of Payments by raising their custom duties, introducing a wide range of import quotas and imposition of exchange controls (government restrictions on the transactions related to foreign exchange, where purchases involving foreign exchange transactions cannot exceed receipts in foreign exchange). The resurgence of this ideology continued till the end of World War II, post which several trade agreements and newer trading systems emerged to promote free flow of international trade.

12.3 NEED FOR INTERNATIONAL TRADE

Countries engage in trading internationally, when there are not sufficient resources or capacity to satisfy all needs and wants of consumers domestically. By developing and utilising its own domestic resources, a country can produce goods it is capable of, create surplus and then trade internationally to buy goods and services from abroad which it is not capable of producing.

The concept of international trade goes back to almost 10,000 years ago, when there were not much defined modern states and national border concepts. It goes back to the time when ships and pack animals were the only mode of trading among people.

The countries today, globally, would not be able to survive without trading internationally. With greater size and increasing population, there is an increase in needs and wants of nations domestically, which a country may not be able to produce, given its resource base. Hence, import and export relations worldwide are an integral part of survival for every economy.

Now, we know the reason behind exporting of goods by a country. But why does a country go for importing of some goods and services? This question can be answered based on the reasons below:

- **Price**: A country may produce something at a relatively lower price than another country, which may produce it at a higher cost.

- **Quality**: Every country has its own set of resource base which might differ from other countries, and hence can produce goods it is capable of making by using its own resource base. So, if country A can produce product 1 using its own resources and country B produces product 2 in a similar line, they can import goods from each other which will be of much superior quality than had they produced both domestically, without trading.

- **Availability**: Nations are not well equipped to produce all goods and services domestically. Hence, trading is a source of availability of all goods domestically.

- **Demand**: With increasing population, demand for goods and services increase. Hence, importing of goods become necessary.

12.4 ADVANTAGES AND DISADVANTAGES OF INTERNATIONAL TRADE

Trading internationally has the following **advantages:**

1. **Economies of Scale**: When a country produces goods and services, it produces them in surplus. This surplus is being traded internationally. Since, higher volumes of goods are being produced, the cost of producing each good is reduced i.e., the country attains economies of scale.

2. **Comparative Advantage**: Trading allows countries to specialize in production of goods and services, it is capable of producing, using its resource base.

3. **Competition**: Selling goods and services internationally boosts both the foreign and domestic markets. Domestic suppliers and consumers are aware about the foreign competition in terms of prices and quality of goods and suppliers would ensure the quality and price of their goods in order to meet the global competition.

4. **Transfer of Technology**: International trade enables transfer of technology among countries, especially from a developed to a developing nation. Foreign companies are also approached by the developing nations to set up local manufacturing units and help in infusion of such technologies in the production of local goods.

5. **More Job Creating Opportunities**: Increasing in international trading also leads to creation of more job opportunities in both domestic and foreign countries, thereby reducing unemployment rates.

However, there are certain **disadvantages** associated with international trade such as**:**

1. **Over-dependence** adversely affects demand: One of the major cons of trading internationally is exposed to both favourable and unfavourable events globally. Any unfavourable event in the global front may affect the demand for domestic goods and can even lead to higher risks of unemployment and reduced economies of scale.
2. **Unfair for Start-ups**: new start-ups or companies may not be able to flourish or may not be able to expand both its resources and experience to compete against the bigger foreign firms.
3. **National Security Threats**: If a country is highly dependent on imports for strategic industries (such as food, energy or military equipment), the exporters may be forced to take up a decision which might be unfavourable to national interests.
4. **Burden on Natural Resources**: Every economy has a limited resource base, but if it decides to welcome the entry of more foreign companies, the natural resource base may tend to drain faster.

12.5 THEORY OF ABSOLUTE AND COMPARATIVE ADVANTAGE

International trade is now a global necessity. No country can better off without trading internationally. David Ricardo, an economist and a member of the British Parliament, in the year 1817, argued in his paper "On the Principles of Political Economy and Taxation" stating that, free trade and specialization can benefit all trading partners, including a country which happens to be relatively inefficient. To understand this, we need to dive into the concepts of Absolute and Comparative Advantages of trade.

Let us take for example, that there are two countries, Home and Foreign, producing two goods- Cheese and wine. To keep things simple, we assume that each country has only one factor of production- Labour. The unit labour requirements (labour hours required to produce a unit of a good) to produce cheese and wine in Home country is given by a_{LC} and a_{LW} while that in Foreign is denoted by a^*_{LC} and a^*_{LW}.

One might think that to determine which country will produce cheese and which country will produce wine, all that is need to be done is to compare their unit labour requirements in production of cheese and wine. If $a_{LC}<a^*_{LC}$ (case I), we can say that the Home labour is more efficient in producing cheese than Foreign. Similarly, if $a_{LC}>a^*_{LC}$ (case II), we say that the Foreign labour is more efficient in production of cheese than Home. The **Theory of Absolute Advantage** states that

when one country can produce a good with lesser units of a factor of production compared to another country, then the former country is said to have an **absolute advantage** in the production of that good. In case I, Home country is said to have an absolute advantage in the production of cheese whereas in case II, the foreign country is said to have an absolute advantage in the production of cheese. However, in a global scenario, where there are more than two countries engaging in trade, absolute advantage alone is not sufficient in explaining the pattern of trade.

The **Theory of Comparative Advantage**, however, brings in the concept of opportunity cost, to determine the gains from trade. A country has a comparative advantage in producing a good if the opportunity cost of producing the good, in terms of other goods, is lower in that country compared to other countries. The term opportunity cost refers to the amount of one good that is to be forgiven to produce one extra unit of another good. From our example, if we want to derive that Home is more productive in cheese and less productive in wine than Foreign, we can assume a relative comparison of the unit labour requirements for both goods, in both the countries, in the form,

$$a_{LC}/a_{LW} < a^*_{LC}/a^*_{LW} \ldots\ldots. \text{(i)}$$

or, to be precise, we can write it as,

$$a_{LC}/a^*_{LC} < a_{LW}/a^*_{LW} \ldots\ldots. \text{(ii)}$$

This states that the ratio of the labour required to produce a pound of cheese to that of a gallon of wine is lesser in the Home country than that in the Foreign. This ratio of labour requirements is nothing but the opportunity costs of producing cheese in terms of wine and the comparative advantage theory is defined in terms of opportunity costs. So, from (i) and (ii), we can say that Home has a comparative advantage in the production of cheese than the Foreign. Foreign, on the other hand, will have comparative advantage in the production of wine than Home and both the countries will gain from trade by exporting the goods in which they are having comparative advantage.

Does a country benefit from having Absolute Advantage in all goods?

One can only imagine that a country with higher-income levels, higher number of skilled workers, technologically advanced equipment and the latest advanced production processes can have an absolute advantage in all goods. US, for example, have the ability to produce both computers and

roses. As roses usually can be grown in the warm temperatures, how hard it might be, for US, to supply roses in winter, especially in the month of February and on the eve of Valentines Day? The flowers have to be grown in heated greenhouses which involve great expenses in terms of capital investment and other scarce resources that are required to grow roses. Those resources could have been put to produce computers.

Suppose, US grows 1 million roses for sale on Valentine's Day. The resources required to grow those roses could have produced 100,000 computers. Then the opportunity cost of 1 million roses is 100,000 computers. Now, if those 1 million roses could instead be grown in South America, it would be extremely likely that the opportunity cost of those roses in terms of computers would be lesser than that in United States. This is because, growing roses in South America is easier as it is summer in February rather than winter. On the other hand, South American workers are less productive than their US counterparts in the production of computers and thus computer production in South America will yield lower computers (say 30,000 computers) than it would have been in US. So, the opportunity cost of 30000 computers is 1 million roses.

These differences in opportunity costs raise the possibility of mutually beneficial trade agreements between US and South America. Let US stop growing roses completely and produces only computers while South America shifts its resource base completely in the production of roses than computers. The resulting changes in production are given in the Table 12.1.

Table 12.1: Changes in Production pattern of Roses and Computers (Hypothetical)

Country	Roses (in millions)	Computers (in thousands)
United States	-01	+100
South America	+01	-30
Total	0	+70

From Table 12.1, it is clear that the world is producing just as many roses as before, but the global production of computers saw a rise. So, with increase in production of computers by US and that of roses by South America, there is an increase in the world's economic pie, which in turn, also leads to increase in standards of living.

Thus, it can be concluded that even if a country has the ability to produce all goods, it can still benefit from trading with other countries, as a result of **comparative advantage**.

Activity 1

Look at India's exports in 2019-20. Top 5 export commodities should be considered in terms of value (say Rs. Crores). Now try to see whether the trade theories you have learnt can explain why India exports these products. (You can look at Economic Survey 2019-20 where top 100 principal commodities exported are published).

12.6 INTRA-INDUSTRY TRADE AMONG SIMILAR ECONOMIES

According to the theory of Comparative Advantage, a country can produce goods in which it specialises to a certain degree and then trade them off globally. However, a significant proportion of trade is **intra-industry** trade – trading of goods within the same industry, among fairly similar economies like US, Japan, China, Mexico, and the European Union. But why do similar economies engage in intra- industry trade? Well, this has three reasons:

- **Gains from Specialization and Learning:** Intra- industry trade between similar economies produces economic gains as it allows both the firms and the workers to learn and innovate on particular products and often on some very particular parts of the **Value chain**- production of goods in different stages. For example- An Apple Macbook may be designed and engineered in the US, parts might be supplied from Korea, assembled in China and advertised and marketed by Japan. A large part of contribution in this splitting up of the value chain goes to newer up-gradations in communication technology, information-sharing services and transportation services. Instead of production of an entire product in a single large factory, all the above steps can be done operating in different places and different

economies, thereby involving greater involvement of learning, innovation and gathering of skills.

- **Economies of Scale, Competition and Variety:** The concept of economies of scale means that as the scale of production of an output increases, the average cost of production declines. Intra-industry trade among fairly high-income economies involves a lot of competition among products and consumer choices globally, if they go for trading internationally. Had there been no trade, and only one or two large plants were supplying products within a country, the consumers would have been left with little option to choose their products from. Also, little or no level of competition would have existed among the manufacturers globally.
- **Dynamic Comparative Advantage:** In an intra–industry trade, the comparative advantage is dynamic – in the sense that the level of labour productivity does not only depend on climate, geography, education or acquiring of new skill sets. It instead, depends on how a firm engages its workers in specific and specialized learning about different products or product parts, which has been made possible with the splitting up of the value chain. Newer ways of acquiring unique set of skills are evolving with time which keeps on changing the line of comparative advantage for the economies.

12.7 TYPES OF BARRIERS TO INTERNATIONAL TRADE

The most common barriers to international trade are tariffs, quotas and non-tariff barriers.

Tariffs are taxes imposed by governments on the imported goods. Quotas, on the other hand, are trade restrictions imposed on the quantitative number of goods that can be imported or exported during a particular period.

The effects of both tariffs and quotas are same i.e., both aim at lowering of imports and protecting the domestic producers from the foreign competition. A tariff raises the price of the imported good in the tariff imposing country, which in turn, reduces the demand for, and eventually the supply of the good in the tariff imposing country. Quotas, on the other hand, put restrictions on the amount of goods to be supplied to the quota imposing country, which in turn, raises the price of the product within the quota imposing country, thereby reducing its demand among the consumers of that country.

Non-tariff barriers include regulations imposed on product content or quality, product standards, packaging and shipping regulations, harbour and airport permits, heavy customs procedures, etc.

Activity 2

Find out the principal barriers to India's products exported to countries like USA, EU and Japan. Do you see any similarity? (Look at WTO I-TIP portal)

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12.8 MEASURES TO REDUCE BARRIERS TO INTERNATIONAL TRADE?

Free trade refers to elimination of all barriers to international trade. Several numbers of organizations and trade agreements are working out to ease the barriers to trade, thereby promoting more of trade and mutual economic gains from it. Some of the important initiatives taken to remove those barriers are discussed below:

1. **General Agreement on Tariffs and Trade (GATT)**: Post the Great Depression and World War II, international trade faced stringent cross-border restrictions. To eliminate those, twenty-three nations came forward and united in 1947 to sign the General Agreement on Tariffs and Trade (GATT). GATT encouraged free trade through proper regulation and reduction in tariffs and also provided a forum for resolving trade related disputes among its signatories.

2. **World Trade Organization (WTO) and Regional Trading Agreements (RTAs)**: Founded in 1995 by the members of GATT, located in Geneva, Switzerland and with approximately 159 member countries at present, WTO encourages global trade through lowering of trade barriers, introducing multilateral trading systems through Regional Trading Agreements (RTAs), enforcement of international trade rules and providing a forum

for resolving trade disputes. It is also empowered to monitor a country's trade policy and can guide the "guilty" members in eliminating all disputed trade restrictions imposed, if any. Non-discrimination is the core principle of WTO, and its members have committed not to favour any one trading partner over others. An exception to these is the Regional Trade Agreements (RTAs), which are discriminatory by nature – in the sense that only its member signatories can enjoy more favourable market-access conditions. The RTAs aim at facilitating trade between its signatories but do not raise trade barriers with the other trading countries.

WTO member countries can enter into the RTAs under specific conditions which will cover: i) formation and operations of customs unions and free trade areas covering trade in goods, ii) regional or global arrangements for trade in goods between developing member countries and iii) agreements covering trade in services. In general, RTAs must cover all trade in goods and services and help in promoting more of free trade among the countries under RTA.

As of June 2016, all WTO member countries now have an RTA in force.

3. **The World Bank and the IMF**: The primary determinant in helping the poorer nations or the less developing economies to involve as active members in the global trading system is by providing financial assistance. This has been a major shared goal of two international organizations – The **International Monetary Fund (IMF)** and the **World Bank**.

   The IMF lends financial assistance to the needy economies, with conditions imposed, which might include some of the tender financial or economic reforms.

   The World Bank, on the other hand, provides economic assistance to the poor and the least developing economies so as to ameliorate the lives of the people through community-support programs which are mainly designed to ensure the provision of better health, education, nutrition, infrastructure and other social services.

4. **Trading Blocs**: In some parts of the world, a group of countries have integrated to allow free flow of commodities and services among their mutual boundaries. Such groups of countries are known as Trading Blocs.

The **North American Free Trade Association (NAFTA)** – (agreement signed for mutual flow of trade among the US, Mexico and Canada) and the **European Union (EU)** (signed by 27 countries of Europe to open their borders for free trade) are the two most powerful trading blocs at present.

Activity 3

Find out the major Regional Trading Blocs in the world and try to write a brief note on each of them. (Go to commerce.gov.in)

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12.9 INDIA'S FOREIGN TRADE: RECENT TRENDS

India's Gross Domestic Product (GDP) reached to US$ 2.88 trillion (Rs. 203.39 trillion) in 2019-20 through tremendous acceleration in the twin channels of trade and capital flows into the country over the last two decades.

India generated a trade surplus of US$ 13.59 billion between April and November, 2020, with exports (of both goods and services) amounting to US$ 304.25 billion and imports totalling to US$ 290.66 billion (as per data from the Ministry of Commerce and Industry). The Government of India is looking forward to grow exports, thereby creating a pool of more jobs for the educated and talented youth, as well as, for the semi and un-skilled workers of India.

As per sources of RBI, its foreign exchange reserves now stand at US$ 583.13 billion (Rs. 42.75 trillion) as of December, 2020.

India's external sector, during 2020-21, witnessed a series of MOUs (Memorandum of Understanding) signed for:

(i) Strengthening the cross-border cooperation in the electricity sector with the United States

(ii) Strengthening the cross-border cooperation in the area of securities, with Luxembourg

(iii) Technology cooperation in the road infrastructure sector, with the Republic of Austria

(iv) Cooperation in the fields of Health and Medicine, with Cambodia (valid for a period of 5 years)

(v) Making education materials accessible to children with hearing disabilities, in cooperation with NCERT, and

(vi) Strengthening the bilateral trade between India and Mexico through cooperation in the sectors like pharmaceuticals, medical equipment, health care, agro-products, fisheries, food processing and aerospace.

India's foreign trade is sooner going to witness a new Foreign Trade Policy (2021-26) with major focus on outlining policies and steps to accelerate domestic production and exports. It has emerged as one of the most sought-after destination for foreign investments due to its trade policies, government reforms and inherent economic strengths, alongside recent technological and infrastructural developments across the country. It is expected to raise its exports (of both goods and services) to Australia by US$ 15 billion in 2025 and US$ 35 billion by 2035.

Activity 4

1. Find out the largest and significant trading partners of India.

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2. Write a short note, using internet resources, on the Initiatives taken by the Indian government to boost its exports under the Foreign Trade Policy, 2015-20.

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12.10 SUMMARY

International trade allows countries to engage in buying and selling of goods across their geographical boundaries, and can ensure productivity efficiency of the trading economies at the same time. Despite bearing a few disadvantages like exposure to national security threats, depletion of domestic natural resource base, creation of highly competitive forums for the newer start-ups to flourish and adverse effects on the domestic demand on account of any unfavourable global scenario, foreign trade ensures that a country attains economies of scale, can specialise in production of goods and services given its natural resource base, regulates the prices and quality of the commodities traded globally, facilitates the transfer of technologies among the trading countries and helps in creation of employment opportunities globally. A country cannot benefit from trade if it has absolute advantage in the production of all goods and services as it eliminates the scope of specialising in the production of goods and services as well as trading with other countries. It can benefit from trade only if it has comparative advantage in the production of goods and services, which accelerates the productive efficiency of that country. However, trading globally also involves some barriers in the form of tariff and non-tariff measures that are being imposed by the government, and which may have an impact on the prices, quality and quantity of the goods traded. To curb those barriers, several international organizations (such as the World Bank, the IMF, GATT, WTO) and agreement bodies (such as the RTAs and the trading blocs) have come into being, which work towards encouragement of free trade, reduction as well as regulation of the tariff barriers, solving of trade disputes among the global trading partners and ensuring improvement in living standards and employment rates worldwide.

12.11 KEY WORDS

Economies of Scale: Economies of scale refer to the cost advantages experienced by a firm when it increases its production of output. These cost advantages arise because of the inverse relationship that exists between the per-unit fixed costs and the quantity of the units produced. The greater the

production of output, the lower is the per-unit fixed cost. It also ensures a fall in the average variable costs due to the operational efficiencies that arise with the increase in the scale of production.

Intra-Industry Trade: International trade that occurs within similar industries rather than between any two or more different industries. Intra-industry trade is highly beneficial as it stimulates the innovation, ensures significant production efficacy and exploits economies of scale.

Non-tariff Barriers: Barriers other than tariff which restrict trade. Major ones are sanitary and phyto-sanitary measures, labelling requirements, technical barriers to trade, inspection etc. Developed countries are skilled in applying these measures to restrict trade in products of interest from developing countries.

Quotas: These are quantitative restrictions on trade. Such barriers are more restrictive than tariffs since it outright by prevents the flow of goods. In case of tariffs the change in flows also depends on elasticity.

12.12 SELF-ASSESSMENT QUESTIONS

1. Define International Trade. Why is International Trade beneficial for a country? Discuss.
2. What has been the world trade pattern during historical times?
3. State two advantages and disadvantages each of international trade?
4. Briefly explain the concepts of Absolute Advantage and Comparative Advantage Theory of International Trade? Give suitable examples to illustrate the concepts.
5. Do you think that a country can benefit from trade if it has Absolute Advantage in all goods? Explain.
6. What types of barriers affect International Trade? How can they be managed?
7. What are Trading Blocs? State an example of one such trading bloc.
8. How does India's external sector look like in the upcoming years? Will it be an engine of growth? Discuss.

12.13 REFERENCES/ FURTHER READINGS

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UNIT 13 SOURCES OF GLOBAL FINANCING

Objectives

After reading this unit you should be able to:

- identify various sources of global financing that a country can opt for;
- define Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI);
- explain how international money markets function; and
- analyse the trends in India's global sources of financing.

Structure

13.1 Introduction

13.2 Foreign Direct Investment (FDI)

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13.1 INTRODUCTION

International Trade has now become an integral factor to determine a country's economic growth prospects. However, trading across national borders does involve costs which are to be incurred by the domestic exporters (or importers) such as costs associated with the shipment of merchandise, import payments, costs associated with selling goods to authorised third parties of sale, etc.

A country with a financial robustness can be able to incur all its expenses related to foreign trade. However, in due course of time and with strengthening of cross-border relations among trading partners, various sources of trade financing have come up, which may ensure complete safety to both the importers and exporters of a country, the most important among them being the strengthening of global financial market operations. This unit will make you familiar with various sources of global financing that a country can opt for, while engaging in cross-border trading.

Countries are involved in cross-border transactions given flow of goods, services and capital. This requires dealing in a number of currencies. Further, the financing of transactions through various means also assumes a lot of importance. Transactions may be settled in advance or at a later date. This requires a well functioning global financial system. Countries may be capital surplus or deficient. The movement of capital across countries follows certain rules. In this unit we are going to look at some of the popular means of global financing.

13.2 FOREIGN DIRECT INVESTMENT (FDI)

Foreign Direct Investment (FDI) can be defined as an investment made by an individual or a firm of one country into the business interests of another country. In general, FDI occurs when an investor set up business operations or purchases assets in a foreign company. If an American multinational company, for example, intends to set up its operations in India or New Zealand, either by partnering with a local firm or by opening up its own branch, it is considered as an FDI.

FDI is actively operational in open economies that are capable of offering a trained labour force and remarkable economic growth prospects for an investor to invest. It involves both capital investment as well as provisions of management or technology.

FDI can be done in multiple ways which may include entering into a merger or joint venture with a foreign enterprise or opening of a subsidiary or an associate firm in a foreign land.

The threshold for a FDI to establish a controlling interest in the business making decisions of the foreign company is set as per the guidelines of the Organization of Economic Cooperation and Development (OECD) which is a minimum 10% stake in a foreign based stake.

Types of Foreign Direct Investment (FDI)

FDI is commonly categorised as:

- **Horizontal FDI**: It refers to the investor establishing a business operation in a foreign country, similar to that operating in the home country. For example, a cell phone service provider in US opening its stores in India.

- **Vertical FDI**: It refers to setting up of different business-related activities, from the investor's main business, in the foreign land. For example, a manufacturing company in US may wish to

set up a company supplying raw materials or parts, or may wish to merge with a local company supplying materials, in the foreign country.

- **Conglomerate FDI**: A type of FDI in which a company wishes to make an investment in a business, in a foreign country, which is not related to its current business in the domestic country. Such an investment, by an investor doesn't involve any prior experience, they usually opt for a joint venture in a business already operating in that foreign country.

Activity 1

India recorded the highest ever FDI inflows in the Financial Year 2020-21. Identify the sectors that attracted the highest FDI during 2020-21. Also, identify the top investors that invested during FY 2020-21. (You may consult the DIPP's website)

13.3 FOREIGN PORTFOLIO INVESTMENT (FPI)

Foreign Portfolio Investment (FPI) refers to investments by residents of one country in a foreign country's securities which include shares, bonds (government or corporate), convertible securities, infrastructure securities, etc. Those investing in these securities are termed as the Foreign Portfolio Investors.

FPI is one of the major components of the capital account for a country and is reflected in the Balance of Payments (BoP). It consists of passive ownership, unlike FDI, where investors do not have any control over ventures or direct ownership of property or stake in a company.

FPI is mainly encouraged by the differences in equity price scenario, bond yield, prospects of growth, rate of interests, dividends and rate of return on capital in the foreign country's financial assets.

In case of India, Securities and Exchange Board of India (SEBI) has stipulated the criteria for FPI to be less than or equal to 10% of capital in a company in the year 2016, while above 10% will be considered as FDI.

13.4 EXTERNAL COMMERCIAL BORROWINGS (ECBs)

External Commercial Borrowings (ECBs) can usually be defined as the commercial loans (debt-based funding arrangement between a business and a financial institution such as bank, to finance major capital expenditures or operational costs of a company) which can be in the form of bank loans, securitized instruments such as floating or fixed rate bonds, partially, optionally or non - convertible preference shares, buyer's credit or supplier's credit availed from the non-resident lenders with a minimum average maturity period of 3 years.

Following are the main **advantages** of ECBs:

a) ECBs are allowed by the Government of India, as a source of financing existing as well as new investment projects, at a much cheaper rate.

b) ECBs are mainly encouraged in the infrastructural areas such as telecom, railways, power, urban infrastructures as well as Small and Medium Enterprises (SMEs).

c) ECBs can be accessed both under Automatic and Approval route. Those accessed under the Automatic route do not require any approval from the Government of India or the Reserve Bank of India (RBI). Such ECBs are usually applied for investments in industrial sector, infrastructural sector or some specified service sector in India. The ECBs which come through approval from the RBI/Government of India falls under the Approval route.

d) ECBs have other advantages such as diversification of the investor's base and providing international recognition to the companies.

ECBs have some **disadvantages** too. To mention among them,

a) ECBs tend to increase a country's external debt and as a result increase the borrower's foreign exchange rate risk.

b) Such foreign currency fluctuations may lead to a loss which may succeed the savings in interest costs.

To avoid these, there is a capping set on the ECBs in a financial year and an overall cap on the ECBs in different sectors, which are subject to change by the RBI/Govt. of India.

Activity 2

ECBs, the largest component of India's external debt declined by 5.8 per cent at end-September, 2020. This may be due to India opting for ease of doing business policy measures during the pandemic. It may also be due to reduction in economic activities due to the pandemic. Write a brief note on the same. (You may consult the Economic Survey, 2021)

13.5 INTERNATIONAL MONEY MARKETS

The international trade and foreign direct investments have, by far, witnessed a large significance across the globe, when it comes to expanding its base for trading goods and services across national borders, as well as, as a source of global financing. The purpose of international money markets hereby comes into action, which makes this financing much easier, through facilitation of borrowing of foreign currencies for financing its imports or debts.

The international money markets usually comprise of the following:

i) **The Eurocurrency Markets:** Any freely convertible currency, which is deposited in a bank, outside the country of its origin, is termed as a Eurocurrency. The US dollars, for example, if deposited in a bank in London or Singapore are termed as Eurodollars. US dollar deposits in Hong Kong or Malaysia is termed as Eurodollar deposits. Such kinds of deposits are being maintained in a foreign bank or a foreign branch of a domestic bank. Such banks, which accept deposits and facilitate loans in foreign currency, are termed as Euro banks.

ii) **The Eurobond Markets:** Eurobonds are bonds traded in any freely convertible currency outside the country of its origin. Eurobonds are either frequently grouped together by the currency in which they will be denominated such as Eurodollars or Euro-yen bonds. The

significance of the Eurobonds is that they help organizations or countries raise capital with the flexibility of issuing them another currency.

The issuance of the Eurobonds is usually handled by a depository bank or an international financial organization, on behalf of the borrower, which underwrites the bond and takes the guarantee of purchasing the entire issue. The Eurobond markets have seen enormous growth since the 1980s and a much wider range of credits are being issued at present, which includes emerging market corporates and sovereigns and structured notes (asset and mortgage-backed securities).

iii) **Euro Notes and Euro-Commercial Papers:** The Euro banks issue short-term note issuance facilities (SNIFs) or simply note issuance facilities (NIFs), as a low-cost alternative of Eurobonds, which permits the borrowers to issue their own short-term Euro notes, that are distributed by those Eurobanks to other foreign countries or companies apart from the borrowing country or company. These are short-term debts issued by large corporate houses with excellent credit ratings.

NIFs usually include:

1. Various contract features offered by Multiple Pricing Components which include a market-based rate of interest and quite a few more fees known as participation, facility and underwriting fees.

2. Other fees that are charged annually or based on full size of the NIF.

Under the NIFs, the notes that are being issued are also at times referred to as the Euro Commercial Paper, if they are not underwritten.

Following are the differences between the US and Euro CP:

1. The maturity period of a Euro CP, on an average, is twice as long as that of an US CP.

2. The Euro CP is significantly traded in the secondary market whereas the US CP is traded by its actual investors.

3. Central and commercial banks as well as corporations are also an essential part of the investor's base in case of Euro CP whereas US CP holders are mainly confined to the money market funds.

13.6 FOREIGN AID

Any kind of an assistance that a country voluntarily transfers to another country in the form of a gift, grant or loan is known as a Foreign Aid. It is usually offered by the developed nations to the developing or least developed nations during the times of a natural calamity, economic crisis or during political instability. According to the United Nations, the developed countries are required to have an expenditure share of at least 0.7% of their gross national income on foreign aid.

Types of Foreign Aid

An international aid can be granted as follows:

- **Foreign Direct Investment (FDI):** Private FDI by multinational companies is a primary type of foreign aid in the form of foreign development assistance. They are usually in the form of equity holdings of foreign assets by non-residents of the recipient country. US companies, for example, may engage in FDI by purchasing shares of an Indian company.

- **Foreign aid can be in the form of several development tools** which are being funded by the government agencies or foreign non-profit organizations to tackle problems associated with poverty. This usually comes in the form of humanitarian assistance from the wealthier countries which are the member countries of the Organization for Economic Cooperation and Development (OECD).

- **Engaging in foreign trade** is a third primary type of foreign aid, where a country's openness to foreign trade may lead to development process, especially among the least developed (or poorer) countries, along with political stability and economic freedom.

- **Bilateral Aid**: This kind of foreign aid is prevalent, where the government of one country transfers money or other kind of assets, directly to the recipient country. An example of a bilateral aid is the American bilateral aid programs which aim at spreading economic growth, development and democracy.

- **Military Aid**: It is also a form of bilateral aid in which a nation involves in purchasing of arms or signs direct defence contracts with the US. The federal government, in some instances, procures the arms, and transport them to the recipient country. Israel receives major military aid from the US.

- **Multilateral Aid**: Similar to bilateral aid, multilateral aid is provided by many governments, instead of one, to the recipient country. In this case, a single international organization (such as the World Bank) collects funds as donated by governments of different countries and transfers the same to the recipient country. Multilateral aid comprises a very small part of the US agency for international development foreign aid programs.

... **Humanitarian Assistance**: It is a form of aid which is usually provided in times of natural disasters, political instability or a severe economic crisis. Such kind of efforts gets a higher amount of private funding than other types of aid.

South Asia received more funds from the advanced economies during an earthquake, which recorded a magnitude of 9.1, and was triggered by a tsunami, killing around 2 lac people.

13.7 TRADE FINANCING

Financing is an important part of trading goods and services abroad. The exporters may require financing while buying or manufacturing of goods whereas importers may require the same for the purpose of inventory investment or procuring goods and services from foreign land.

There are five principal means of trade financing, which are being ranked in terms of its increasing risk to its exporters:

i) **Cash in Advance:** This offers the greatest protection to the exporter as the transactions are done mostly in cash, either before or after the arrival of the goods. An exporter usually prefers cash terms, in situations like a political instability in the importing country or when the buyer's credit seems to be risky or doubtful, as these may cause delays in payments or even completely stop the fund transfers. Cash in advance, in such cases, enables the exporters to both finance its production and reduce marketing risks.

ii) **Documentary Credit (D/C):** A documentary credit (or documentary letter of credit) is a form of letter which is addressed to the seller (or exporter), written and signed by a bank acting on behalf of the buyer (or importer). In the letter, the bank promises to honour the drafts drawn on itself if the seller conforms to the specific conditions as mentioned in the documentary credit.

The major types of a Documentary Credit that are prevalent include:

a) Revocable D/C: Means of arranging payments, which doesn't carry a guarantee.
b) Irrevocable D/C: Refers to the means of arranging payments under specific permissions of all parties concerned, including the exporter.
c) Confirmed D/C: A Confirmed D/C is the one which is issued by one bank and confirmed by another, obligating both the banks to honour any drafts drawn in compliance.
d) Unconfirmed D/C: Under an unconfirmed D/C, it is the obligation of only the issuing bank, without being confirmed by another bank.

e) Transferable D/C: This type of D/C issues the right to the beneficiary to instruct the paying bank for making the credit available to one or more secondary beneficiaries. A D/C is non-transferableif not authorized in the credit.

iii) **Draft**: Drafts are commonly used means of financing in international trade. It is an unconditional order in writing, usually signed by the seller (or exporter) and addressed to the buyer (or importer) or the importer's agent – ordering the buyer to pay on demand or at a fixed future date, the amount mentioned on its face. It is also known as a bill of exchange.

A draft serves three most important functions, which include:

a) Provision of written evidence, in clear and simple terms, of a financial obligation.
b) Enabling both the parties (importer and exporter) to potentially reduce their costs of financing.
c) Provision of a negotiable and unconditional instrument (i.e. the payment must be made to any holder despite any disputes over the principal commercial transaction).

Drafts can be negotiable under the following conditions:

- It must be in a written format
- Must be signed by the issuer (drawer)
- Must be an unconditional order to pay
- Must be a certain sum of money
- Must be payable on demand or at a fixed future time
- Must be payable to order of bearer

Drafts can be:

a) *Sight Drafts*: Drafts paid on presentation or else dishonoured.

b) *Time Drafts*: Drafts payable at some specified future date. A matured time draft is termed as its usance or tenor. A time draft is said to become an acceptance, if it is being accepted by the drawee by authorizing with a signature and date. A draft, which is accepted by a bank is termed as banker's acceptance and that drawn on and accepted by a commercial enterprise is termed as a trade acceptance.

c) *Clean Draft*: This kind of draft is not accompanied by any other official papers and is usually required for non-trade payment settlements only. It is primarily focused on pressurizing any non-complaint debtor to pay or accept the draft, failing which may lead to damage to its credit reputation.

d) *Documentary Draft*: Such a kind of draft can either be Sight or Time Drafts and are usually accompanied by other official documents which are to be delivered to the

drawee on payment or on acceptance of the draft. The official documents include mainly the bill of lading in negotiable form, the commercial invoice (of trading), the consular invoice (document certifying the shipment of goods and shows information such as the consignor, the consignee and value of the shipment) and an insurance certificate.

iv) **Consignment:** Under a Consignment, goods sent are only shipped but are not sold to the importer. In this kind of an arrangement, the goods are left in possession of an authorized third party to sell. The exporter (consignor), on selling goods in consignment, draws a portion of the profits, either as a flat rate fee or commission. Goods and services sold in the consignment arrangement mode can be of low-commission and low time- investment way of selling.

This mode of financing usually involves large risks. The exporter need to carefully verify the credit risks involved along with the availability of foreign exchange in the importer's country. If the buyer defaults, it becomes difficult for the exporter to collect the payments for his shipment.

v) **Open Account**: Open account selling involves shipping of goods first and then billing the importer later. The credit terms are arranged between the importer and the exporter and in these kinds of arrangement, the exporter doesn't have much information about the importer's obligation to pay. Open account selling is usually preferable with the foreign affiliates or with a customer with whom the exporter has long history of favourable business dealings.

Open account selling has seen a vast expansion with increase in the volume of international trade as it has witnessed an improvement in credit information about the importers and a greater acquaintance with the exporting in general.

The benefits of an open account selling include greater flexibility of trading and payments (no specific dates of payment set), lower costs and fewer bank charges.

Banks and Trade Financing

Banks are usually involved for providing loans or a documentary credit, when it comes to financing international trade. However, as financing became a fundamental aspect of trading, the banks – especially the international banks have started evolving as well. The banks now provide financing of discrete trade deals, and assist with comprehensive solutions to trade needs such as facilitation of combined lending by banks with subsidized funds from the government export agencies, international leasing, other non-bank financing resources, along with other associated political and economic risk insurance.

Activity 3

With the help of internet sources, find out the predominant method of payments opted for by Indian firms to finance trade.

13.8 AMERICAN DEPOSITORY RECEIPTS (ADRs)

A negotiable certificate which is being issued by a US Bank and represents a specified number of shares of a non-US company which is being traded on a US Exchange is termed as an American Depository Receipt. They are measured in US Dollars and are transacted in the US stock market similar to stocks of any other US company, and are issued in US by an US bank.

The ADRs are listed in either New York Stock Exchange (NYSE) or the American Stock Exchange (AMEX) or the National Association for Securities Dealers Automated Quotation (NASDAQ).

ADRs offer the US investors, an opportunity to purchase stocks of foreign companies, in the US market in US dollars. On the other hand, it also benefits the foreign companies by enabling them to attract American investors and trade its share in the US market without the hassle and expense of listing in the US stock exchanges.

ADRs can be:

Sponsored ADRs: When a foreign company enters directly into an agreement with the depository bank of US for maintaining records, communicating with the ADR holders, payment of dividends and other shares.

Non-sponsored ADRs: When there is no involvement of any US depository bank and the foreign company wishes to establish itself in the US trading market with the help of a broker-dealer.

There are **three** types of ADRs:

Level 1 ADRs: These ADRs does not intend to raise capital. They are listed in the exchange and traded only over-the-counter market. No information about the issuer company in the US Securities Exchange Commission (SEC).

Level 2 ADRs: These ADRs are either listed on an exchange or quoted on NASDAQ. They too, like the level 1 ADRs, do not wish to raise capital but are required to file annual reports in the US Securities Exchange Commission (SEC).

Level 3 ADRs: The most important category of ADRs which are issued to raise money and trade in the US exchange market. They are also required to file annual reports to SEC.

In case of the sponsored ADRs, a fee is charged by the US depository bank, while making an agreement with the foreign company for rendering its services to the ADR holders. Such a fee is called the Custody fee and is often deducted from the gross dividend, by the foreign company, and the net dividend is paid to the ADR holders.

13.9 GLOBAL DEPOSITORY RECEIPTS (GDRs)

A bank certificate which is issued in more than one country for shares in a foreign company is termed as a Global Depository Receipt. They are listed in two or more markets – mainly the US and the Euro markets are denominated in a freely convertible foreign currency.

A foreign company issues shares to the depository bank of the share trading country. The Depository bank then issues GDRs against these shares to the investors of the other foreign countries. In case of GDRs, the GDR holders are not the shareholders of the share issuing company. The depository bank becomes the main shareholder of the issuing company and also has the voting rights.

13.10 TRENDS IN INDIA'S GLOBAL SOURCES OF FINANCING

Indian domestic markets have been sluggish when it comes to raising of funds for their business needs. As a result, Indian companies have shifted their focus towards international fundraising sources through several traditional and non-traditional channels available, some of which are mentioned as follows:

1. **Equity based channels** are open for the Indian business environment as a source of financing. They may be in the form of:
    a) **Foreign Direct Investment policy**, which is a liberal and balanced policy, where global investors can invest in almost all sectors. Saving in a few sensitive sectors like retail and insurance is quite easy, as 100% foreign equity participation is available.
    b) **Investment funds**, in the form of pure financial funds, sovereign funds, social impact funds or other related institutions have at least two main attractions for investments – investing in the industry or sector of the target business customers, and having an appetite to invest in India.
    c) **Partnership with foreign companies through Joint Ventures** works best if the partnering companies belong to a technology and capital rich country. Joint venturing allows access to the capital markets of the foreign partnering companies for additional equity and low-cost debt. Some European economies have the foresight to invest in emerging market economies in order to overcome the saturation in their own investment sectors.
    d) **Listing of Indian companies in stock markets** and other alternative investment exchanges is available in most of the advanced economies. This can be available through organic listing by means of an Initial Public Offering (IPO) or with the help of a reverse merger with an already existing company followed by stock offerings. Canada, US and Singapore stock markets are best suited for such kind of transactions.
    e) **Equity guaranteed debt** rely on the reputation of a Joint Venturing partner or a significant partner shareholder that floats a loan for the Indian companies and guarantees it locally, thereby making fundraising by Indian businesses easier and more economical.

2. **Debt based instruments** include major banks and other financial institutions as primary choices of raising debt funds from foreign sources. Quite a handful of commercial banks in major economies like US, Japan, China, UK, Switzerland, Canada and Taiwan provide funds to Indian businesses for financing their business needs. Debts from banks and large financial institutions such as the World Bank, the International Monetary Fund, the US International Development Finance Corporation and the Asian Development Bank are mostly suited to finance Indian projects of economic importance.

Smaller banks and debt funds are mostly accessible to the MSME Sectors for providing loans and funds with an interest rate higher than the larger institutions but lower than the domestic funders. Partner companies through joint ventures provide channels for funding through their own banking relationships, by leveraging low-cost debt themselves followed by a low-cost debt as another alternative lender to its own business under the current Indian external commercial banking policy.

Besides business development funding, there are certain European banks that are willing to finance global businesses of their clients by providing debts at economical rates in emerging economies like India as long as the foreign partner company is a part of the business.

Alongside these financing options, Indian business firms are now open to **trade factoring** in businesses with reputable importers of their products. **Export finance** is greatly beneficial when buying capital goods from advanced economies like US, Canada, China and Japan. Extreme low-cost financing options are also available for the right customers in India.

Setting up of a subsidiary of an Indian company in a foreign capital rich economy is another option of securing low-cost finance, as many schemes and opportunities for growth can be availed using this method for the reputable business firms in India.

Foreign Capital markets are thus, a valuable source of financing for the Indian businesses and it is a perfect opportunity for them to access such global capital markets and accrue more of capital reserves in the near future.

Activity 4

1. Identify any top 5 Indian companies (using internet resources) and their sources of global funding.

2. Can you list world's top 5 private equity companies that have invested in India. (Use Internet sources like GlobalEdge^{TM})

13.11 SUMMARY

Global trading is an essential factor for determining a country's economic growth prospect. But it also comes with some costs involved during purchase and sale of merchandise across geographical boundaries, such as costs associated with the shipment of goods, payments to exporters, etc. A country with a strong financial backbone can bear all its financing of trade expenses. However, with the passage of time, cross-border trading relations strengthened and gave rise to several sources of trade financing have emerged for the trading countries in the form of Foreign Direct and Foreign Portfolio investments, External Commercial borrowings, Foreign Aid, American Depository and Global Depository Receipts and International money markets (which includes Eurocurrencies, Eurobonds, Euro notes, etc.). As far as the payment terms between the exporter and the importer is concerned, five additional means of financing trade have been identified and ranked as per the associated risks for the exporters. Such means include payments through Cash in Advance, Drafts, Documentary Credits, Consignments and Open Account Selling, and banking operations.

Countries can now opt for their sources of funding, as required, without involving much of the depletion of its foreign stock of reserves.

13.12 KEY WORDS

Credit Rating: A quantitative assessment of a borrower's credit worthiness in terms of a particular debt or financial obligation. It can be assigned to any entity, be it an individual, a company or a sovereign government.

Small and Medium-sized Enterprises (SMEs): SMEs are non-subsidiary, independent firms (or business operations) which employ fewer than a certain limit of employees. Small and medium enterprises generally have 50 or less than 50 employees while micro firms operate with at most 10, or in some cases, 5 employees.

Organization for Economic Co-operation and Development (OECD): OECD Founded in 1961 and headquartered in Paris, France, is a 38-member intergovernmental economic organization which aims towards encouraging economic progress and trade worldwide. It also provides a forum for its member countries who are committed to democracy and market economy to compare their policy experiences, identifying problems and seeking answers to them, and identifying good practices and coordinating domestic and international policies of its members.

National Association of Securities Dealers Automated Quotations (NASDAQ): Founded in 1971, NASDAQ is an American stock exchange market based in New York City and ranked second in the list of stock exchanges after the New York Stock Exchange. It is owned by NASDAQ Inc. which also owns the NASDAQ Nordic stock market network and various US Stock and Option exchanges. NASDAQ allows its investors to buy and sell stocks in an automated, transparent and a faster computing network.

Morgan Stanley Capital International (MSCI): Founded in 1969 the MSCI is an American financial company which is based in New York City and serves as a global provider of fixed income, equities, hedge fund stock market indexes, multi-asset portfolio analysis tools and Environmental, Social and Governance (ESG) factors products.

Joint Venture (JV): A type of business entity created by two or more parties, generally characterised by shared ownership, shared returns and risks, and shared governance. Companies usually engage into a Joint Venture to access to a new market (especially emerging markets), gaining efficiencies of scale, sharing risks for major investments or projects and for accessing newer skills and potentialities.

Initial Public Offering (IPO): An IPO (also referred to as Stock Launch) is a public offering in which shares of a company are sold to institutional investors and retail investors. An IPO is usually underwritten by one or more investment banks, who arranges for the shares to be listed in one or more stock exchanges.

13.13 SELF-ASSESSMENT QUESTIONS

1. State the differences between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI).
2. What are the advantages and disadvantages of External Commercial Borrowings (ECBs)?
3. What are the components of International Money Markets? Explain in detail.
4. What is Foreign Aid? State the types of Foreign Aid.
5. What are American Depository Receipts (ADRs) and Global Depository Receipts (GDRs)? Explain.
6. State and explain the five principal means of trade financing.
7. What are the various types of Documentary Credits? Explain their purposes.
8. What are the five major trends that India's financial account is witnessing in the recent times? Elaborate.

13.14 REFERENCES/ FURTHER READINGS

UNIT 14 TECHNOLOGICAL ENVIRONMENT

Objectives

After reading this unit you should be able to:

- discuss the important aspects of technological environment in international business;
- analyse recent trends in technological environment;
- describe the impact of technological environment on international business; and
- highlight the recent trends in technological advancements adopted by Indian businesses.

Structure

14.1 Introduction

14.2 Trends in Technological Environment

14.3 Impact of Technological Environment on International Business

14.4 Trends in Technological Advancements

14.5 Summary

14.6 Key Words

14.7 Self-Assessment Questions

14.8 References/ Further Readings

14.1 INTRODUCTION

The technological environment portrays a country's potential in terms of the availability of raw materials and machinery which is required for the manufacturing of goods. No company can possibly control the global environment and hence adaption of technologies may seem to be quite essential for the businesses to ensure a competitive advantage. This unit will essentially focus on making one understand why technological environment is important for a business to flourish both nationally and internationally, what are the advancements in technology that can help a business expand and finally what are its impacts in the global market.

Technology is crucial for the entire global business world. Even though lowering of trade barriers have theoretically helped expand markets and production potential worldwide, the advent of technological innovations has added a practical reality to it. In today's world, almost every business operation and transaction involve a significant use of technology.

Let us look at some of the important aspects of technological environment in the international business.

1. **Business Necessity-** In the earlier days, everything in business was performed manually. Introduction of technology has helped revolutionize the business concepts and models, thereby bringing tremendous growth in trade and commerce. It has provided a faster, more convenient and more efficient way of performing business transactions.
   Some of the technological uses in an international business environment include accounting systems, management information systems, logistics tracking systems, customer relationship services, point of sales systems, etc. These have enabled businesses to expand globally as well.

2. **Communication with Customers-** In today's world, technology has a great importance in building relationships with customers. In a global business environment, quick and clear interaction with the clients (globally) is a necessity as websites take hours to respond to customer queries. Alongside, technological innovations in the transportation services have enabled fast shipment disbursal in a shorter span of time across national borders. Language translation systems have enabled employees of a business/organization to interact with customers worldwide, understand their concerns and resolve their issues. This is how a global business environment benefits from a stronger communication system globally.

3. **Efficient Business Operations-** Technological advancements in a global business environment have helped them understand their cash flow needs, needs for free flow of shipment, needs for proper inventory management, need for proper tracking and monitoring of shipment and need for proper communication with clients in a much more efficient and faster processes, thereby saving time and physical space. Low-cost internet services and World Wide Web have also enabled businesses to grow internationally and cater to global needs easily.

4. **Impact on Business Culture and** Relations- With the advent of technology, stronger communications are being facilitated among employees of a business, customers, shipment coordinators and all those who are associated with a global business environment, directly or indirectly. This has helped to keep aside all social

tensions, distrust and formation of cliques which might have a negative impact on the business to a large extent. Instead, it has helped develop a strong bond between the employees and customers of a business.

5. **Business** Security- Businesses are often subject to threats. In order to expand globally, businesses have started expanding online through internet services. This gets them exposed to cyber-crime threats. With the technological innovations in line, especially in the form of Artificial Intelligence (AI) and Machine Learning (ML), businesses can now monitor and secure financial, transaction, client related data, various confidential reports and other proprietary information. With the help of cloud computing, employees can now access to all business and client related data along with communicating with their clients and other employees, while travelling or working remotely, even without direct active management of data.

6. **Research** Capacity- All businesses need to expand – both the line of production capacity and client base. Technology helps meet the business with newer opportunities by facilitating enough Research and Development (R&D). This enables a business realise newer dimensions to expand both domestically and internationally, along with facing competition in the world market. Internet has enabled businesses to access data on global markets without facing the costs of travelling or risks of creating separate production plant abroad.

Activity1

Give an example of a business where technology is playing a special role. What aspects of technology are being used in your chosen business?

14.2 TRENDS IN TECHNOLOGICAL ENVIRONMENT

A global business environment cannot function without a technological environment. The more the technology evolves, the greater the benefits obtained by a business from it. Following are some of the important ways in which technology has helped a business environment globally:

Biotechnology

Biotechnology can be defined as an amalgamation of technology and science, more specifically, the creation of agricultural or medical products with the help of industrial usage and manipulation of living organisms. With the rise of digital innovations such as cellular phones, computers and wireless technologies, advancements have not only evolved in efficient communication and productivity, but has also extended its effect towards medical and agricultural use.

Following biotechnological advancements have been witnessed worldwide:

i) The fusion of science and technology have bred a common bionic man immune to diseases through advanced technologies in prosthetics, cell regeneration through stem cell research and laboratory-engineered drugs which helps in preventing or curing of diseases like HIV or cancer.

ii) Pharmaceutical advancements are widespread through the raw material reserves of China, arrival of biotech companies such as Genentech and New Merck (which is acquired by Swiss biotech company Serono) and India's emergence as a major supplier of effective and affordable drugs of the largest and most generic pharmaceutical company Ranbaxy.

iii) Biotech companies have made attempts to discover genetic abnormalities, and therefore medical solutions through exploration of organisms at the molecular level or formulation of compounds from inorganic materials that reflect organic substances. Manipulation of DNA in the laboratories also extended beyond common human research.

iv) The demand for corn-derived Ethanol as a fuel alternative saw a rise in US due to uncertain future oil supplies. However, usage of corn as a bio fuel not only increased the price of fuel but also created an imbalance between

the corn that is used as a bio fuel and the corn consumed. Hence, many global companies are working in collaboration, towards creation of genetically modified seeds like drought-tolerant corn and herbicide tolerant soybeans. These technological advancements have not only led to nutritionally advanced crops but also helped fight hunger worldwide.

v) Biotechnological advancements have also benefitted the meat industry worldwide. The collaborative work of researchers in US and Japan, in eliminating the gene which might be responsible for certain ailments in animals, has engineered a solution to the outbreak of certain diseases arising from meat consumption. Furthermore, animal cloning has rose to high demand, where a copy of pre-existing animal DNA, can speed up the food production with the increase in production of meat or dairy- producing animals. US, South Korea, Japan, Australia, Italy, New Zealand and China are among the most active animal-cloning countries.

vi) Technological advancements have also been witnessed in laser surgeries in correcting eyesight, creation of vaccine to fight against emerging viruses or production of more nutrient-content food products.

In all, biotechnological advancements are actively emerging up to cope with the worldwide issues of hunger and poor healthcare.

E-Commerce

Availability of internet and the growing demand of the worldwide web has brought a drastic change in the marketing of goods and services. It has enabled firms ranging from small enterprises to large industrial houses realise the potential of online global marketing along with facilitating online buying and selling of goods and services globally. The low entry costs of internet have, by far, permitted the small and medium enterprises (SMEs) having low capital investments to emerge as significant global online marketers at a rapid pace. On the other hand, internet has also enabled the customers to get an explosive range of information about varied products and services online, alongside providing the potential to obtain products from the low-priced suppliers in the world. This has helped in increasing the standardization of prices across national borders, thereby narrowing the differences in prices, as consumers are now more aware of prices globally and purchase products online accordingly.

Telecommunications

An important dimension of the technological environment in the international businesses is telecommunications. From hardwiring a city/locality to provide its residents with a telephone service, to wireless telecommunication services through usage of cellular phones, pagers and other such services, technological leapfrogging is quick across the globe. Additionally, technology has also merged the cellular phone and the computer, due to which growing number of people is now getting access to web services, through their cellular phones. This growth is warmly acceptable as businesses, domestic or global, will not be able to prosper without an efficient telecommunication system. Telecom advancements in the form of 4G and 5G services have fostered closely knit global businesses.

Transportation

Technology, apart from bringing innovations in the telecommunications and computers, has also brought in some major developments in the transportation sector, ever since the period of World War II. The most important developments came in the form of introduction of commercial jet aircrafts, super freighters and containerization (system of intermodal freight transport using intermodal (or shipping/ISO) containers of standardized dimensions), which has simplified the transhipment from one mode of transport to another. While the containerization led to reduction in the cost of shipments to longer distances, commercial jet aircrafts helped in the reduction of the travel time for businessmen.

Globalization of Production Processes

A network of strong worldwide communications has become essential to facilitate globalization of production for any multinational firm. Texas Instruments (TI), an US based electronics firm, for example, have approximately 50 plants across 19 countries. A system on satellite-based communicational lows the firm to coordinate and monitor its production systems in all those 50 plants located globally, that include the planning of production processes, accounting and financial planning, marketing of products, facilitation of customer services and human resource management.

Globalization of Markets

The globalization of production and innovations in the transportation sector has facilitated the globalization of markets too. The advent of containerization has led to faster and reliable transhipment of goods within and across national boundaries, thereby leading to creation of global markets. Commercial jet aircrafts have facilitated low-cost movement of people around the world. Low-cost global communication networks, such as the World Wide Web have led to global exposure of goods and services from around the world,

through online marketing. Global communications and global media together help in reducing cultural distances among countries and encouraging a convergence of tastes and preferences of consumers worldwide, thereby creating a world market for consumer goods. For instance, one can find a McDonald's restaurant in India, as it is in New York, buy a Sony Walkman in Delhi, as it is in Berlin or grab a Levi's jeans in Paris as it is in US.

Technology Transfer

It is a process that permits the flow of technology from a source to a receiver. Both the source and the recipient of such technological transfers can be an individual, company or a country. The source, in this case, is the owner or holder of the technological knowledge, while the receiver is the beneficiary of such knowledge. With the advancements in the technological environment, the transfer of such technological innovations is spreading rapidly across world markets, especially benefitting the less developed and the emerging economies. The source of such technological knowledge usually happens to be the advanced economies.

Block Chain

Block Chain is a system of recording information that completely prohibits to change, hack or cheat the system. It is essentially a digital ledger of transactions that is duplicated and distributed across the entire network of computer systems in the Block Chain.

Block Chain and Block Chain-based distributed ledger technologies are creating a tremendous impact both in the global trade supply chain as well as in the global trade financially. It not only makes the shipment of goods more convenient, but also simplifies the long and tedious process of obtaining a Letter of Credit (LoC), a payment mechanism that is used in global trade.

Several trade organizations such as the Dubai Chamber of Commerce and Industry have launched an initiative to implement Block Chain technology for addressing world trade issues like high costs and lack of transparency and security. Deloitte, have assisted an Indian private sector bank in redesigning its LoC issuance service, using a Block Chain based solution that reduced the issuance time from 20-30 days to hours. Companies such as Skuchain are by-passing the LoC altogether and is providing real-time tracking of goods and inventory financing that reduces the risks associated with transactions, and allows the trade financers to provide working capital relief to all the supply chain partners at the lowest cost of capital in that supply chain.

Artificial Intelligence (AI) and Machine Learning (ML)

Artificial Intelligence (AI) refers to the simulation of human intelligence in machines or computer systems that are programmed to think and act like humans. This term is also applied to any machine that functions like a human – mind such as learning and problem – solving.

Machine Learning (ML), on the other hand, is a part of Artificial Intelligence (AI). It is a study of computer algorithms that can be improved automatically through everyday experience and with the use of data.

Both AI and ML can be used to optimise trade shipping routes, manage vessel and truck traffic at ports and translate e-commerce search queries from one language to another and respond with the translated inventory. It also works more towards making global trade sustainable, rather than focusing only on efficiency gains and better customer services. An example of this is the launching of Global Fishing Watch by Google in 2016, a real-time tool based on Machine Learning which is used to curb the illegal means of fishing through provision of a global view of commercial fishing activities based on satellite data and ship movements. Governments and other organizations can also use this to track suspicious behaviours and work on developing sustainable policies accordingly.

Trading Services through Digital Platforms

Trading services have now become much more convenient online. With the help of several online digital platforms such as 'Upwork', users can now look for service providers worldwide for a vast range of services, and can be able to find anything from an accountant in US, to a web developer in Japan, or a virtual assistant in India. Certain start-ups have come up with an online learning digital platform, that enables pairing up educators with children across the globe to provide online education on a wide range of courses. An example of such an online digital learning platform is VIPKID which connects American educational instructors with Chinese children for teaching English online. Many online digital platforms have also come up to connect customers with various professional service providers in just few clicks.

3D-Printing Services

3D-Printing (also known as Additive manufacturing) is a process of creating a three-dimensional solid object from a digital file. This is done using an additive process in which an object is created with successive layers of material until the object is created.

3D-Printing has the potential to make the production of goods, from food to medical supplies and to great coral reefs, accessible to everyone. In future, it may also lead its way into the businesses, disaster sites, outer space etc. The significance of 3D- printing on a

global business environment is still a debatable topic. Some studies predict that with the mass-adoption of high-speed 3D-printing and lower associated costs, global trade might see a decline by approx. 25 per cent, as 3D- printing involves lesser manpower and reduces the need for importing goods. Others argue on the account of complexities and reality associated with mass-manufacturing using 3D-printing. Regardless of being positive or negative, the impact of 3D-printing seems to have a real impact on global trade, with the efficient and low-priced availability of 3D-printing methods.

Mobile Payment Services

With the advent of M-Pesa, Mobikwik, Google Pay, Phone Pe and other UPI (Unified Payments Interface) methods, mobile payments seem to transform the lives of people and help in linking more people to global market opportunities. As per the World Bank Global Inclusion Database, mobile money payments were a major drive for financial inclusion during 2011-14, especially in the emerging economies, as the number of people who gained access to bank accounts increased by 20 per cent during the same period. This has made people to participate in global trade in a much easier and faster method, either as consumers or businessmen.

Customer Relationship Management (CRM) Software Services

With the expansion of a business across national borders, one needs to essentially look into the customer services and therefore maintaining healthy customer relationships. However, global expansion of business can really make it difficult to keep a proper track on all client records. This is where the CRM software services come into play.

The CRM software helps in creation of a database for all your customer contacts that can easily be accessed by any member of one's team, related to business. This software is very much essential while running businesses on a global scale. It helps to create a database for maintaining the product order histories, concerns raised by consumers, and personal as well as business related information of each individual consumer along with their contact details (phone calls, emails and chats). This information enables a company or a business to track their customer's location, along with the languages that they speak and the local customs that the company may require to be aware of, alongside any applicable trade rules or restrictions.

Cloud Computing Services

Cloud computing refers to an on-demand availability of all computer system resources, especially data storage and computing power, even without direct active management by the user. It is generally used to describe the data centres over the internet.

This technology is especially beneficial for companies working on a global front and where employees need to travel quite frequently or work remotely. With the help of Cloud

computing, an employee can get access to files and essential information regarding their organization from anywhere and can remain connected to its customers as well as office, on filing of reports, sharing of data or communicating uninterruptedly around the globe.

Logistics Tracking Technology

Logistics is an essential part of doing business, especially during buying and selling goods internationally. Execution, receipt and tracking of shipment require a lot of planning, consideration and careful handling as a wrong shipment can have an adverse impact on time, money and customers.

In order to help the companies deal with this task efficiently, an innovative technology in the form of **Logistics Management Systems** have come up. This system helps in planning of trade routes, monitoring of any trade restrictions or problem areas, if any, and track movements of goods and services. It also helps in modifying disrupted trade routes to get the deliveries back on track. **Electronic Shipment Tracking** is nowadays evolving to help in meeting business needs. Cost effective **Radio Frequency Identification (RFID)** devices have evolved to be more affordable and attainable for companies, followed by **Bluetooth Beacons** which emerged as another alternative option for electronically tracking shipments.

The emergence of RFID and Bluetooth Beacons has therefore, helped the businesses in taking advantage of **Automatic Identification and Data Capture (AIDC)** in their supply chains, making it more reliable to manage and track their shipments.

Translation and Language Learning Software and Services

Language barriers can appear to be a real challenge for a global company, especially when it comes to communicating effectively with its customers or business clients. Web-based translation companies have evolved themselves and are still in the process of upgrading their functions every day. Though they sophistically translate and check the communications, it is still suggested to have a professional translator or a fluent speaker to check the communications and avoid inaccuracies, if any.

In order to continue a business with its partner or customer in the long-run, learning of the foreign languages can help reducing expenses or translation costs and can help provide better customer services. In such a case, a plenty of online reputable programmes and software courses can help one learn and improve their foreign language skills.

Activity 2

1. Can you name the latest technologies that are shaping up the following:
   a) Education Sector

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   _____
   _____
   _____

   b) Banking Sector

   _____
   _____
   _____
   _____

   c) Healthcare Sector

   _____
   _____
   _____
   _____

   (You may take help from the internet sources).

14.3 IMPACT OF TECHNOLOGICAL ENVIRONMENT ON INTERNATIONAL BUSINESS

Every businessman or marketer around the globe is now well aware of how important technology is for the businesses and what are its effects on a business environment? There are both negative and positive effects of technology for a business.

Initially, the businesses were dependent on a labour force. But with the rise in technology, businesses do not want to lag behind. They have already started implementing newer technologies to flourish worldwide. Here are some of the ways in which the technology affects the global business environment.

1. Technology helps in diminishing business security risks by hiring best of security specialists for preventing sudden cyber-attacks and with the use of AI and ML, such threats are being minimized.

2. Technology ensures business growth by enabling almost all business actions to be automated, thereby reducing involvement of human labour. This has helped in increasing the sales, revenue and profit for the businesses and the usage of internet have enabled them to grow online and expand worldwide.

3. Online presence through social media channels is one of the business-oriented targets that the enterprises are trying to fulfil to grow along with the broadening of its client base. Technological tools that help businesses identify their preferred content, optimum time of posting their service contents, automated posting and location- specific targeting to expand their business, are actually helping to establish the business better in the online world. Tools like Google analytics are playing a major role in this.

4. Technology helps in increasing employee productivity for a business through various computer programming and software such as AI, ML, and cloud computing that helps businesses to process more information, sitting anywhere in the world, than manual methods, thereby reducing much of human involvement in such tasks. Organizations are also using fundamental business technologies for employee performance appraisal information in the online framework to supervise the performance of its employees and create measurable goals for their employees to achieve and thereby sustain the business objectives.

5. Business technologies are now allowing companies to outsource certain business functions to other businesses in the national and global business framework. Technical support and customer service are the two most common outsourced functions. Outsourcing therefore helps companies lower their business costs and focus on completing their business functions, which they are best at. With the help of several technological innovations, businesses can also outsource their functions to the least expensive areas possible, including those in foreign countries as well.

Activity 3

Explain with an appropriate example, how technology has enabled international business. What would be the progress of the sector chosen if technology had not progressed to the level it has?

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14.4 TRENDS IN TECHNOLOGICAL ADVANCEMENTS

Several new technological creations have been developed for the Indian businesses to improve their business performances using more advanced technologies such as Robotic Process Automation (RPA), Artificial Intelligence (AI) and Analytics. The top five trends in technological innovation with respect to Indian firm business environment, during the period 2019-20 are as follows:

1. **Emergence of Hyper-automation** – An infusion of the RPA, AI and Analytics creates a new technology called Hyper-automation which enables optimisation and modernisation of processes. Hyper-automation uses a mix of rising technologies such as Machine Learning, RPA, Intelligent business management software and AI, to take the automation of organizational processes to a higher level. A mix of devices supports this process to function exactly as human workforce, post which the solution can even carry out the decision-making process independently. This process results in increasing rates of productivity, broader access to data and helping decision makers to carry out better decisions for their customer leveraging analytics.

2. **Increase in Artificial Intelligence (AI) Usage** – AI is now blending into the daily routine of human workforce with more reliable and advanced AI engines. High-speed optical fibre internet is now available at every home in India, enabling the data to develop devices that are more human friendly and easily handled. AI will also help in streamlining the non-value-added tasks to be performed, therefore freeing up humans to invest their time in more meaningful and other important business-related activities. More and more, Indian companies have now started investing in data analytics, AI and ML to train and enrich their workforce with various analytical skills, thereby enabling them to take advantage

of advanced technologies. Some of the uses of data analysis include algorithms for analysing fingerprint data systems fingerprint data, finding of errors and giving insights, and also suggesting new data that should be analysed along with.

3. **Conversational AI and Natural Language Processing (NLP)** – NLP has earned a great popularity through the use of voice search and voice assistants, thereby creating a paradigm shift in AI, in many Indian companies. The NLP helps in increasing visualised dashboards and reports within their Business Intelligence systems. A number of Q&A or chat mediums are being used to gain real-time answers and useful visualizations from data-specific queries. Computational linguistics is still a major area of ongoing research using NLP, considering its ability to improve efficiency and insights, according to which NLP will turn out to be beneficial in the process of optimizing data exploration and improving communications in the upcoming future.

4. **Autonomous Things (AT)** – One of the most revolutionary innovations in technology in the Indian business environment is the Autonomous Things (AT). AT allows multiple devices to work in collaboration using limited or no human dependency input. It has the ability to surpass process automation to integrate advanced AI for delivering communications and behaviours with more natural interactions with humans and the business environment.

5. **Data Storage Technology Innovations** – With the increased amount of data, the concept of Software Defined Storage (SDS) system has evolved, which combines the software and hardware from different manufacturers for operating together resulting in an enormous efficient data handling performance, making it more secure and easier to perform.

Alongside, another popular trend in technology has been witnessed through hyper scale data centre construction, which is prevalent in the data centre industry since 2019, allowing Indian business sectors to adopt Data Centre Infrastructure Management (DCIM) solutions, in order to cater the demands of modern business environment. The year 2020 saw an increase in the enterprises who have been designing and implementing smart data centres for operators to integrate proactive sustainability and efficiency measures.

Activity 4

Given the recent changes in technological environment worldwide how far do you think India has progressed on these fronts? Give some views about the present state in India in the areas mentioned in this section.

14.5 SUMMARY

Technology has its own significance when it comes to connecting businesses worldwide and expands a global market. Not only does it limit its efficacy to improving the global business relations, but also has an impact on day-to-day business activities including customer relationship management, production planning, logistics tracking, ensuring proper shipment and delivery of goods, financial planning, cost management, database management etc. Up-gradations in the technological environment in the form of Artificial Intelligence, Machine Learning, Cloud Computing, Block Chains, Natural Language Processing and several others have helped businesses to move from more of manual and less of technology base to more of technological base and less of manual labour involvement in its day-to-day activities. It also assists in tracking suspicious behaviours and ensures security to data hacking threats. Connecting customers worldwide and addressing their concerns in just a few clicks have also been improvised with the help of several technological inventions. In short, technology has now become the soul of a global business environment.

14.6 KEY WORDS

Genetically modified seeds: Seeds designed to make the plants/crops more resistant to rain, drought, pests, diseases, etc.

Globalization: A process by which businesses or enterprises develop international influence or start operating on a global scale.

Algorithm: Set of rules that are followed in calculations or other problem-solving operations, by a computer.

Analytics: A systematic computational analysis and the resultant information obtained using data or statistics.

14.7 SELF-ASSESSMENT QUESTIONS

1. What is the importance of technology in international business environment?
2. How has biotechnology brought about advancements in international business environment?
3. How has internet services and telecommunications revolutionised international business environment?
4. What is Technology Transfer? Give an example.
5. Define Block Chain, Artificial Intelligence (AI) and Machine Learning (ML). Mention some areas where they are frequently used.
6. How does Customer Relationship Management (CRM) software changed the way business is done?
7. What is Cloud computing? What is its contribution?
8. How has Logistics Tracking Technology helped in improving the international business environment?
9. How does technological advancement impact international business? Discuss.
10. State any two technological advancements that India is witnessing to have impacted her international business pattern.

14.8 REFERNCES/ FURTHER READINGS

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